PITMAN'S ECONOMICS SERIES

General Editor: PROFESSOR J. H. JONES, M.A.

Professor of Economics and Head of the Commerce Department, University of Leeds

FINDING CAPITAL FOR BUSINESS

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BY

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PREFACE

WHEN I was asked to write a short book on the methods of Finding Capital for Business in this country, I consented light-heartedly. It would be a matter of consulting the authorities and of giving a *résumé* of the best current thought on the subject—as much as the professional man dare undertake in these days when the demands of others leave little leisure. Unfortunately, I found that the authorities, if they existed, were not readily available. The memory of the evening spent among the index cards at the library of the London School of Economics is still a distressing one. There was nothing left to do but, on the basis of experience, to examine the ways in which business attracts capital to itself. I am only too conscious of the shortcomings of the result; but it may act as an incentive to someone far abler and with more leisure to write an exhaustive work on the organization of capital in England.

Just as this book went to press, the Macmillan Committee issued its report; but the publishers very kindly made the necessary arrangements to enable me to incorporate certain of the Committee's recommendations in the final chapter.

DAVID FINNIE.

22nd July, 1931.

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FINDING CAPITAL FOR BUSINESS

CHAPTER I

INTRODUCTORY

THE methods by which business enterprises attract capital is a subject of very human interest. It touches all of us, for if we are not numbered among those who are seeking capital, nothing is surer than that we shall at one time or another be sought after to provide capital. In this little book we shall adopt the standpoint of the seeker. There are many surveys of almost every part of the economic field, but the dynamics of the subject is seldom considered. We shall discuss the methods of finding the capital necessary to start a new business or to develop an established one, and look at some of the ways in which this capital should be employed so as to attract to itself the resources of those credit and other institutions which, in many enterprises, supply the greater proportion of the real capital employed.

Private Undertaking and Public Company. Our subject falls into two parts, finding capital for the private enterprise and for the public company. In the first case we have the undertaking where the management or their friends own the capital—generally speaking, the smaller type of business, whether it assumes the form of one-man business, firm, or private limited company. In the second case we have the public limited company—generally speaking, the larger type of business,

where the management and the ownership of the capital may be, and usually are, quite distinct. Capital for the first type of business is raised privately, but for the second type it is, as a rule, obtained from the public, and the Legislature, during the last hundred years, has found it necessary to regulate strictly the manner and substance of the appeal to the public for capital so gathered.

The most striking difference between the two classes is to be found in the relationship of management to ownership of the capital. In the partnership and in the private company, ownership of capital and management are closely associated. The owners of the capital are few in number. There cannot, for instance, be more than twenty partners in a firm, nor more than fifty shareholders in a private limited company. In the public company, on the other hand, the number of shareholders is unlimited, and, owing to the extreme ease with which their shares can be marketed through the medium of Stock Exchanges, the composition of the shareholders is continually altering. The shareholders change, but the directors remain; management of the business is divorced from ownership of the capital. The same directors are in control year after year. The usual rule is that one-third of the Board retire each year, but the re-election of retiring directors is taken as a matter of course, unless the Board is itself shaken by internal feuds, or unless something so catastrophic has happened to the company's business that a majority in value of the shareholders able to vote is forced to organize itself under competent leadership, and takes the trouble to appear at a general meeting of the members of the company. This is almost as rare as a thorough-going revolution in a well-ordered country, and its prospects of success are just as hopeful.

It must not be taken for granted that this divorce of capital ownership from management in the public company is necessarily a matter of regret. The Board knows infinitely more than the shareholders about the business of the company, and the conscientious Board has the interests of the company at heart. It takes the long view. The modern shareholder usually takes the short view. He is in the company quite frankly for what he can get out of it, as he may probably sell his holding to-morrow, or next month, or next year. The tendency is for him to want the maximum return on his investment in the minimum time. So the interests of the management and of the owners come into conflict. Many a good Board, towards the end of the company's financial year, spends anxious hours in devising means of concealing profits from its shareholders so that the company may have hidden reserves to fall back upon when the lean years come.

Generally speaking, the private enterprise is the smaller type of business, and the public company the larger type. The normal progression is from the one-man business or partnership to private limited company and then to public limited company. Usually a business is started through the enterprise of a few men; when it has proved itself, additional capital is obtained from friends, and a private limited company is formed to limit their liability. As it grows and its success is established, the public are invited to participate by subscribing the capital necessary for expansion. It was the introduction of the principle of limited liability, allied to easy marketability of the shares of a public company, that made possible the enormous aggregations of capital necessary to support the huge concerns that have sprung up as a corollary to the Industrial Revolution.

There are, certainly, enterprises of great size that take the form of firm or private company, but they are almost invariably family concerns that have grown during several generations, and it may safely be predicted that sooner or later they will pass into the second class. Some kinds of business, nevertheless, irrespective of their magnitude, do not seem to take kindly to the form of a public company. The best example is that of the contractor, which, even when it attains the importance of the enterprises controlled by the late Lord Cowdray, usually remains in the private class. The contractor's life, as contrasted with that of the man engaged in commerce or industry, is a strenuous, uncertain, and speculative one. The prizes may be great, but success depends in an exceptional degree on the judgment and capacity of the management. Such businesses are usually family businesses, and the owners of the capital take a personal share in the management.

On the other hand, we need only look at the published annual summaries of new companies registered to observe the smallness of the capital of many public companies. Although this form of organization is primarily designed for the large concern, it can often be put to good use by smaller ones, especially when additional capital is sought for an old, well-established business.

Still, for the purpose of our discussion of the methods of finding capital, our division is a convenient one. We shall consider first the private enterprise, dealing in Chapters II to IV with the ways of finding capital for a new business, and in Chapters V to IX with the ways of raising additional capital for an established business. In Chapters X to XIV we shall examine the methods by which public companies attract capital to themselves.

CHAPTER II

FINDING CAPITAL FOR THE NEW BUSINESS— FROM OWN RESOURCES AND FROM STRANGERS

THERE are a hundred and one ways in which a man may seize opportunity. He may want to open a retail shop or start a wholesale business; he may have in mind the exploitation of an invention or an improvement on some process, he may have obtained a valuable contract and require the means to fulfil it, and so on. His problem is how to obtain the necessary capital to make use of the opportunity. The money may come from three main sources—

1. His own savings and resources.
2. His friends.
3. Strangers to be taken into partnership.

Own Resources. It is axiomatic that the best way of financing a new business is to do it from one's own resources. It is much easier to find capital for extending an existing business than for launching a new one. The latter is always to a certain extent a leap in the dark; but if a man with his own capital tries out a new enterprise, a year or two's experience in a small way soon brings to light any flaws latent in his original scheme and shows him the most profitable avenues for development. Above all, on the basis of work done, he is in a position to draw up a statement of profits, and to make an estimate on solid grounds of future profits that would accrue from the introduction of fresh capital.

Banks and the New Business. We have not mentioned banks as a potential source of capital. What banks can do in regard to the new business is best

included under the heading of one's own resources. To lend money a bank must have security. It is no use going to a bank manager and asking him to lend money against a promise to make over to him as security at a later date the buildings, or plant, or stock which it is proposed to acquire with the proceeds of the loan. In the first place, he is the custodian of other people's money and he will not take risks. In the second place, there is much competition among his clients for loans, and he accommodates those who have the most easily realizable securities to offer and who want the money for the shortest term. When the business is running and the client can produce audited accounts, the bank can help in many ways, but this is another subject, and one that we shall discuss at a later stage. On the other hand, if the borrower's relations with his banker are good, and he can hand him the title-deeds of his house or other property, his life policy, approved stocks or shares quoted on the Exchanges, or similar security, he may obtain the necessary advance under conditions; but he is then, in point of fact, financing the business from his own resources. The bank will demand a valuation of the land or property by an independent valuer approved by them, and it is essential that there be no existing mortgage or prior claim on such assets. A bank, as a rule, will not lend money on a second mortgage. Indeed, if a second mortgage is desired on any property on which the large banks hold a first mortgage, they may require the mortgagor to repay his loan to the bank. The reason is that if the borrower, as is usual in the ordinary course of business, repays from time to time part of the money lent under the first charge, and at a later date reborrows it, the amounts reloaned in this manner rank in law after a second mortgage of prior date.

It should be remembered that a bank does not give long term loans, and, no matter in what form a loan is granted, there is a saving clause giving the bank a right to recall it on giving due notice. The borrower must take the risk of the bank, in times of financial stringency, requiring repayment. The people who are asked first to settle their debts in such times are those whom the manager does not regard as good customers, or whose liabilities to the bank are proportionately heaviest. It is of the greatest importance for every business man to build up with his banker a reputation for integrity and capacity. The old adage ran: "Deceive not thy confessor, thy physician, nor thy lawyer." Your banker should nowadays be added to the list. He should be treated with complete frankness and straightforwardness, for he can be a very present help in time of need.

Continental and British Banks. There is a big difference between the British and Continental banker in regard to the financing of new enterprises. The British banker regards himself primarily as the trustee of the funds deposited with him, and he conceives it as no part of his function to bear any of the risk involved in establishing a business. Before lending money he insists on having ample security. This is quite in accord with our individualist philosophy, for in business we are still intensely individualist.

On the Continent it is a common practice for banks to assist in the formation of new enterprises. In Germany, during the thirty years preceding the War, banks were prepared to act almost as partners in developing new industries; there were even industrial banks which specialized in this form of business. The War was a testing time for all financial institutions, and our banks, with their conservative policy and their refusal to share

in the risks of trade, emerged in an impregnable position. Yet in justice it must be said that, while Germany lost the War and was thereafter plunged into financial chaos, the German banks have survived in a sufficiently sound condition to enable them to assist very powerfully in the reconstruction of German industry and commerce. The Briton about to open up a new business often sighs for a little of the same spirit of enterprise among our bankers.

From Strangers. Delaying for a moment consideration of the provision of capital by friends, we can look shortly at the possibilities that the new business may have in finding capital from outside sources.

There are three ways in which capital for the new business may be obtained from strangers—

1. By advertisement in the Press.
2. Through an agency.
3. Through a solicitor or accountant.

As a general rule, the introduction of capital by any of these means is associated with the assumption of a partner.

By Advertisement. The columns of the Press are always open to anyone advertising for capital, but to find a partner in a total stranger in this way is an exceedingly risky business. Fullest inquiries must be made about such a prospective partner. His bank references will be taken up as a matter of course, a report, if possible, received from Stubbs or a similar agency, and it is essential to have references from a professional man and from some personal friends of substance. The inquirer should not be content with writing to these referees; he should go and see them for himself. Even if he is satisfied, he should not, if he can possibly help it, tie himself irrevocably under a deed of partnership. A trial period should be arranged, or, if that is a counsel

of perfection, provision should be made in the Agreement for dissolution on either partner giving, say, three months' notice of his intention to withdraw.

It is rarely that capital for the new business is found through advertisement, but an advertisement on occasion leads to the converse case, for it may be answered by someone already engaged in the same or a similar type of business who is prepared to join forces with the advertiser. As this case is rather outside our subject, it may suffice to indicate that it is absolutely essential to have the other man's business investigated by an independent accountant. He is accustomed to investigations, and information is given to him as a matter of course that would not be open to the advertiser. His report, if favourable, should form the basis of the partnership agreement.

Through an Agency. There are agencies that specialize in introducing prospective partners to each other and in finding capital for new businesses. In an ideal world it would be to these agencies that the man in search of a partner with means would naturally turn. As it is, the temptation on the part of such organizations to make a profit, or, rather, to earn their commission, seems to be overwhelming, and there have been so many scandals associated with them that as a class, with certain exceptions, they have been brought into disrepute. Some of them can probably be trusted, but it would require a preliminary investigation to determine the *bona fides* of the one approached.

Through a Solicitor or Accountant. If the necessary capital for the new business cannot be raised among friends, it is best to enlist the help of a solicitor or accountant. They are not open to the same objection as the agencies discussed in the previous paragraph, for the solicitor, certainly, and the accountant, if he is

a member of a recognized body, is governed by the rules of professional conduct. To put it at the lowest, he cannot afford to damage his reputation through making an undue profit on a single transaction. As in either of the methods outlined above, recourse must be had at some stage of the negotiation to the solicitor or accountant, it saves time to approach them in the first instance. They will investigate the proposed business thoroughly. They are brought constantly into contact with all manner of clients, and, if they are satisfied, they may be able to find a suitable partner.

CHAPTER III

FINDING CAPITAL FOR THE NEW BUSINESS— FROM FRIENDS

It is not very often that a man can finance himself wholly from his own resources; strangers are difficult or unsatisfactory, and the people to whom he naturally turns are his friends and their acquaintances. As a general rule it is wise to leave relations severely alone in this connection. This is a sad reflection on human nature, but the number of businesses that find themselves in trouble through the squabbles of relatives who have financed them is amazing. Your friends know you, and in finding capital the confidence and trust that people can place in you are at least as important as your actual proposition. Again and again one finds the most promising schemes turned down solely because, in the opinion of those approached to finance them, the men handling the schemes do not inspire confidence. There is a well-known and successful banker who has provided finance for many an enterprise whose possibilities would have seemed a little nebulous to most of his brethren; but he has seldom made a mistake. "I am not much concerned," he says, "with balance sheets and estimates and statements, no matter how carefully drawn up. I want to see the man responsible for carrying the business through. He is the factor that counts." All the more important is the question of personality in persuading people to invest money in a new business. Herein lies the reason for a man approaching friends; they know him intimately, and are best able to assess his capabilities.

Minimum Capital Required. In these days £1,000–£1,500 is, except in special circumstances, the minimum capital that a new business requires to have any hope of success. The writer has assisted in the formation of successful businesses with a capital of less than £1,000, but in each case the proprietors have held some advantage that was the equivalent of capital. Usually, they had been in the employment of a manufacturer or wholesale dealer, and, as a result of the trust they had earned, they were allowed long-term credits. Although their capital was nominally less than £1,000, it was really far in excess of that figure, for the wholesale dealers or manufacturers, by extending long credit, in fact supplied them with their working capital.

In another instance a shop was opened in an expensive street, and the landlord agreed to forgo the rent for a certain period in consideration of a share in the profits over a number of years; arrangements were made for the supply of certain classes of goods on sale or return terms; and favourable credits were obtained for other classes. In three ways, therefore, the proprietor obtained capital, not in money, but in money's worth.

Of course, there are some types of business that can be started with a few hundred pounds or even less. The small shopkeeper in the country or in the suburbs needs little capital, and the more rapid his turnover the smaller are the resources required. The extreme case is the greengrocer with a wholly cash business.

Keeping in view, however, that £1,000–£1,500 is, as a rule, the minimum capital required, the man who has the best chance of obtaining assistance from his friends is the steady-going fellow who has had some years' experience in the same or a similar type of business to that which he proposes to start, and who has saved £500 or so, which he proposes to make the nucleus of the

capital required. His friends will not take so much convincing if they know that he is staking his own savings; it is the best proof of his confidence in his plans.

Form of the Scheme. The birth of an enterprise is an exciting affair. The initial ideas are developed, at first with many misgivings, but later with the enthusiasm that is inseparable from the creative instinct. The ideas take form, and the creator regards his work and is satisfied. Now comes the testing time, when the proposition must be set down in cold typescript or print, in such manner as will render the written word the basis on which other people will decide whether or not the new business is sufficiently attractive for them to invest money in it.

How Much Capital is Required. The first question to be decided is the amount of capital required to establish and run the business, and this question can be answered only by a very careful examination of the following factors—

1. The expected amount of sales or revenue, rising month by month, from the beginning until the business is in full running order. The average credit to be allowed on sales, and the proportion of cash sales, if any, anticipated.

2. The amount of purchases required in view of the anticipated sales, also arranged on a monthly scale, with an estimate of the stock to be carried. The average credit expected on purchases; the rapidity of the turnover of stock.

3. The initial expenditure on furniture, fittings, and equipment; on the purchase, adaptation, erection, or lease of buildings, etc.

4. Expenses of every kind that will be incurred—

(*a*) Until sales are in full progress and income is flowing regularly into the business;

(*b*) Thereafter to maintain and expand the volume of sales.

5. The amount of capital to be held in reserve.

These factors should be worked out according to the needs of each individual case in the form of a time-table from the commencement of the business until it is paying its way; and then to the end of the first year. An estimate should also be framed of the anticipated income and expenditure in a normal year, and it should be remembered to make a liberal allowance for contingencies, delays in collecting debts, and bad debts.

If the business is a manufacturing one, the calculation of the initial expenditure will be more complicated, and the relation of output to sales, regulated as it must be by two considerations, that of allowing for an adequate profit margin and for seasonal fluctuations in demand, will require close study; yet the principle remains the same.

The results obtained by a consideration of these factors will show in the first place the preliminary and initial expenditure required to put the business on a revenue-producing basis, and in the second place the amount of working capital necessary. It is essential in all businesses, large or small, that these estimates be most carefully made. Over-capitalization is bad, under-capitalization is worse. Nothing stunts the growth of a business like want of working capital in its early stages.

Particulars of the Scheme. When the man starting in business has determined the amount of capital required, he should draw up a full statement of his scheme. He will set out the objects of the business, and how he proposes to carry them out; its suggested extent and scope; his business experience and connections; any special capabilities he may have for this kind of

enterprise; the location of his works or warehouse or shop or offices, and any advantages it may have through proximity to sources of supply or to potential markets; any contracts he may have obtained or be likely to obtain for the sale of his goods; any arrangement he may have made, or be able to make, for long credits for purchases; every pertinent factor he can think of that will tend to assure the success of the business.

He will next put down in statement form the amount of capital he requires, and how he proposes to utilize it. Thus, in the case of a small factory, the statement might be as follows—

Amount of capital required		£
To be utilized thus—		
(1) Erection, adaptation, or purchase of buildings	£	
(2) Plant and equipment . . .		
(3) Tools		
(4) Stores		
Leaving as working capital		

There would follow an indication of the time when the factory would commence production, the extent of the output and of anticipated sales, and, finally, a statement of estimated profits for the first year and for a normal year, perhaps in the form shown on page 16.

In a wholesale or retail business the statement would be much simpler, but the greatest pains should in all cases be taken with the estimates of expenses. Some of them can be accurately determined before a business is started; others are dependent on the size of the sales. It is often a good plan to assume, always on a conservative basis, sales of different amounts, say the minimum and something approaching the maximum expected, and to work out the estimates on these bases.

Estimated Income—

Sales			£
Other income (interest, discounts, etc.)			

Less Estimated Expenditure—

(1) *Cost of Production*			
Cost of materials used	£		
Carriage thereon			
Wages		£	
(2) *Factory Oncost*			
Royalties	£		
Rent, taxes, insurance			
Repairs to machinery			
Depreciation of ditto			
Wages of superintendence			
		£	
(3) *Finished Goods Purchased*			
(4) *Selling Expenses*			
Carriage outwards	£		
Travellers' salaries			
Advertising			
Bad debts		£	
(5) *Management Expenses*			
Office rent, rates, and taxes	£		
Printing and stationery			
Lighting and heating			
Salaries			
Audit fee			
Discount			
Petty outgoings	£	£	£
Estimated net profit showing a return of — per cent on the capital			£

Importance of a Friendly Intermediary in Finding Capital. It is very rarely that the man starting a business is the best man to find the capital for it. He is too acutely interested in getting the capital, and his estimates are therefore liable to undue bias.

He would be well advised to put all his data before an impartial friend, especially if that friend is a business man, an accountant, or a solicitor with a commercial practice. The friend may make sad havoc of the

statement; he may reduce the income estimates and add to the items of expenditure, particularly in order to make allowance for unforeseen contingencies, and perhaps for the comparative inefficiency of the new business during its first year or two as compared with old-established competitors.

The friend, however, is in a position to approach his associates and address them thus: "I have known Smith for years and he is a sound man. He wants to start a business to develop this line. He has £750 of his own and he wants an additional £1,500. I have gone over his estimates very carefully, and here they are, with a statement of his proposition. I think it is a good thing. Take the papers with you, and let me know if you will consider it." If these people also know Mr. Smith, so much the better, but in any event, the presenting of the case by a third party is likely to secure a more favourable reception.

CHAPTER IV

FINDING CAPITAL FOR THE NEW BUSINESS— FROM FRIENDS (*contd.*) FORM OF THE NEW BUSINESS

THE financial form which the business will take is important and must be considered at this stage. There are a number of possibilities, taking forms such as—

1. A one-man business.
2. A partnership (*a*) unlimited, (*b*) limited.
3. A limited company (*a*) private, (*b*) public.

It is, as a rule, injudicious, in the small type of business which we have been considering, to start off with a limited company. The proper time to form a company is when the business has been running for a period. This will be dealt with at length in the next chapter, under the head of finding additional capital. Of course, the friends who put up capital in the first place may, and very often do, insist on the formation of a private company so as to limit their liability, but the whole question may be postponed meantime.

Objections to the One-man Business as an Investment. For the sake of simplicity, we have so far written of *the man* who is going to start a business. In practice, it is always easier for an active partnership of two or more persons to raise capital. The one-man business, no matter what form it takes, does not appeal as an investment like the partnership, for its success is dependent on the health, energy, and honesty of a single life. A business that came recently under our notice is a good illustration, although in this instance it was not a question of finding the initial capital, but

of raising money to cope with expansion. The present capital of the concern, which is carried on as a private limited company, is some thousands of pounds, but as the whole of the shares, with the exception of a few issued to a second shareholder to meet the requirements of the Companies Acts, are held by one individual, it may be treated as a one-man business. For the last few years a dividend of 40 per cent has been paid. It was desired to increase the capital by an issue of 10 per cent preference shares, but the money could not be found. A very experienced solicitor, who was approached, explained his reasons for turning it down. "Mr. C's health may fail, or he may die, and where is my security? Again, I am sorry to say, I have seen so many promising young men get on, and when they have seen their business expand and obtained fresh capital, they have found themselves in command of far more money than they have been accustomed to, and they have gone off the rails. If I had a client who was looking for an active directorship, I should certainly recommend this to him, especially if a proportion of ordinary shares went with the preference ones, for the man who puts his money into a one-man business ought to go in with his money to look after it."

Methods of Meeting these Objections. There was a great deal of sound common sense in those remarks, but a man about to commence in business is not always fortunate enough to have a partner, or partners, associated with him. If he is alone, there are certain steps that he can take to minimize these risks. The dependence on his health may be surmounted by his insuring his life for the amount advanced by his friends, and assigning the policy to these friends, the premium being charged as an expense to the business. In the event of his death, the proceeds of the policy would suffice to

repay the capital advanced, irrespective of the position or the continuance of the business.

Parenthetically, it may be observed that every man setting up in business should make his will, if he has not previously done so, and ensure that proper provision is made, in the event of his death, for the appointment of competent executors or trustees who will carry out his expressed wishes in regard to the winding up or otherwise of the business. He would be equally well advised, in view of the hazards of business, to provide a minimum that would assure the continuity of his dependants' home life by turning over, through deed of gift to his wife or eldest child, such essentials to the existence of a family as his private residence, the furniture and effects therein, and a certain sum in cash—if need be, by a separate life policy taken out under the Married Women's Property Act.

It is usually better to raise capital from a number of friends than to take it all from one. Apart from the question of control in the latter case—and that may, and does many a time, have awkward consequences—there emerges again the risk arising out of dependence on a single life. Should the friend who advanced the money die, the business man may find himself compelled on very short notice to repay to the estate of the deceased the amount of capital the latter had advanced, and it may be difficult, or very expensive, just at that juncture, to obtain fresh capital to replace the money withdrawn.

Appointment of Auditor. The dependence on the honesty, and to a certain extent on the judgment, of a man engaged in business on his own account is lessened by the appointment of a professional accountant as auditor. If the audit is a six-monthly one, and the auditor is given a general supervision of the books, so

much the better. The public accountant, chartered or incorporated, is nowadays more than a mere watchdog of finance. His practice brings him into close contact with every variety of problem that confronts the business man, and full advantage of his experience should be taken by the owner of the small business. A very successful tobacco factory goes so far as to make the auditor, in his capacity not as auditor but as accountant, responsible for the financial transactions of the business. He receives all moneys and makes all payments. Tenders are passed to him to calculate the lowest price on which an estimate can be given. Each month he submits a costing statement of the various lines manufactured, and alterations, if necessary, in the composition of the various blends are made so as to maintain the requisite rate of profit. The active partner is satisfied because he can devote himself to the practical side, while the men who are financing him feel that the element of risk is largely eliminated.

Avoidance of Responsibility for Firm Debts. In this chapter we have assumed that the person providing capital for the young business does not intend to take any part in its management. It should be remembered that, in law, where persons carry on any business together and are jointly interested in the profits or losses of the venture, they become partners, and are each liable, up to the last farthing of their possessions, for the whole of the losses occasioned by transactions of the partnership. At one time, all people sharing net profits were necessarily partners, but now, while the mere sharing of profits is still *prima facie* evidence of partnership, it is not in itself sufficient to constitute partnership, if three conditions are strictly observed—

1. There must be no active participation in the business by the lender.

2. The arrangement between the parties must be clearly stated in writing.

3. This contract must be signed by all the parties.

If A lends £600 to B on the stipulation that he receives one-fourth of the profits of the business as interest, he must, in order to avoid liability as a partner, see that an agreement is drawn up and signed by himself and B, setting out the fact of the loan and the consideration, and negativing any suggestion of partnership rights. A may thereafter give advice or inspect the books, but on no account must he in any way interest himself actively in the conduct of the business, or give anyone reason to believe that he so interests himself, or he will make himself liable, as a full partner, for debts incurred while he so acts.

B, on his part, should take care that in the contract adequate notice—say six months—of intention to withdraw any of the loan should be given to him. Provision should also be made for the preparation of accounts and the procedure to be adopted if the business is dissolved.

Limited Partnership. It sometimes happens that the person desirous of investing in the small business hesitates because, aware of the pitfalls of partnership law, he is afraid lest at some time and in some way he may unwittingly incur the responsibility of a full partner. In such a case, the business may be converted into a limited partnership. On the Continent a firm is a legal person distinct from the partners of whom it is composed, a conception leading directly to the principle of limited liability as regards the partners; and it is a common practice there to have partnership where the liability of the partners for debts of the firm is limited. The Limited Partnership Act of 1907 was an attempt to adapt the Continental principle to the conditions of

this country. Under that Act a person may become a partner in a business and fix the limit of his responsibility for firm debts at the amount of capital which he contributes or engages to contribute. Thus, if he agrees to contribute £2,000, and actually pays in £2,000 to the business, he has no further liability. Should, however, a portion of his capital, say £500, be repaid to him at some time by the firm, he may be compelled, in any proceedings against the partnership, to pay back this £500. A limited partner is in a position very like that of a shareholder of a limited company: if he draws out any part of his contribution while the partnership continues, he is liable for the firm debts up to the amount so drawn out.

A limited partnership is constituted simply by registering at Somerset House a specified form containing the particulars required by the Act. These are—

1. The firm name.
2. The general nature of the business.
3. The principal place of business.
4. The full name of each of the partners.
5. The term, if any, for which the partnership is entered into, and the date of its commencement.
6. A statement that the partnership is limited, and the description of every limited partner as such.
7. The sum contributed by each limited partner, and whether paid in cash or how otherwise.

A limited partner may inspect the books, examine into the state and prospects of the business, and advise the partners thereon. A very common practice is for a sleeping partner, whether he has limited his liability under this Act or not, to insist that all financial transactions above an agreed figure be first submitted to him for his approval. The limited partner has no power to bind the firm, and he must not take part in the

management. If he does, he is liable, as though he were an ordinary partner, for the firm's debts incurred while he so acts.

The Act is rather inelastic, and the limited partnership, notwithstanding its advantages as a form of business organization, has not become popular. Where a person desires to invest in a business and at the same time to set a definite limit to his liability beyond any shadow of doubt, he usually prefers to put his money into a private limited company.

Ordinary Partnership. Fortunate is the man who finds in a congenial friend, prepared to contribute capital and share equally in the management with him, a partner for the new venture. His responsibility is halved, and the business is not dependent on a single life. It may be remarked that it is quite a common practice, and one always worth considering in many trades, to enter into partnership with someone already carrying on business in an allied but non-competitive line. The established business can provide the accommodation and office staff, the same travellers may easily serve both organizations, and there is the advantage of being able to benefit by the experience of the older firm. The arrangement is equally advantageous to the latter, for it enables office and selling expenses to be cut down, and there is, besides, the share in the prospective profits of the new business.

Importance of Partnership Agreement. In however friendly a way a partnership is commenced, it is of the greatest importance that the rights of the parties be carefully and strictly defined in writing in a partnership agreement. The success of a partnership depends on the partners working in unison, and if questions or disputes arise it is desirable that they should be settled by reference to a document made at the time when the

partnership was commenced. The agreement should make provision for the following—

1. Period of the partnership.
2. The capital or proportion of capital to be brought in by each partner.
3. The interest, if any, to be paid on capital.
4. The duties of each of the partners, the salaries to which they are entitled, or the amount of drawings which they may take in anticipation of profits.
5. The manner in which profits and losses are to be shared.
6. Preparation of annual accounts, and audit.
7. Control of the banking accounts.
8. Terms upon which the partnership may be dissolved or a new partner assumed, and the procedure to be adopted in the event of the death of a partner.
9. An arbitrator, to whom disputes may be referred.

Joint Assurance Policy. It is recommended, especially if one of the partners is elderly, that the partners take out a joint life assurance policy for the amount of their interest in the business, and charge the premiums as a business expense. Some of the large insurance companies make a speciality of this form of policy. It will avoid the dislocation of the business in the event of the death of one of the partners and the consequent withdrawal of his capital.

The Manner in which Capital is Provided. The manner in which capital is provided by friends for the new business varies according to circumstances. Usually, it takes the form of cash by way of loan at a fixed rate of interest or carrying a share of the profits earned, repayable at a fixed date or dates, or on certain contingencies, such as the death of the lender. As we saw in Chapter III, when discussing the minimum capital required for the new business, it may also take the

form of extended credits of one kind or another. If payment for plant, or rent, or goods or services is deferred for a time, this is equivalent to a loan.

Bank Guarantee. A banker makes temporary advances to augment the working capital of a business. He does not usually provide the permanent capital. When the initial amount of capital is not large, however, it is sometimes possible to arrange for a bank loan secured by the guarantee of one or two friends. In some parts of the country this is quite a usual method for the young shopkeeper to adopt when he is setting up for himself, and it is always worth trying, especially in the type of small business that will have a fairly active current account at its bank.

In considering the application, the banker will direct attention to the character and standing of the borrower, his prospects of success, the amount of the advance, the period over which it will be required, and, of course, the solvency of the guarantors. If the borrower has a bank account already, he will approach his own banker, tell him of his purpose, and hand him a letter from his friends consenting to give the proposed guarantee. If the banker agrees in principle to the proposition he will take up the banking references of the guarantors, and when he has satisfied himself of their solvency, the accommodation will be granted.

When making the arrangements, particular attention should be paid to the form of the accommodation. It may be a fixed loan or a floating overdraft on current account, and there is considerable difference between the two. In the first case, which is more usual in the South of England, the loan is placed at the disposal of the borrower as and when he requires it, and it is usually repaid at regular intervals. A banker likes to see movement in an account, and he insists on regular

repayments of a loan. In the second case, which is more general in the North of England and in Scotland, the borrower may overdraw on his current account up to the amount secured by the guarantor. This method is more flexible, and, as a rule, it is cheaper, for all amounts paid into the current account from time to time immediately reduce the overdraft. The borrower also is not tied down to making regular payments, and the banker sees the movement he loves in the current account.

The nature of the accommodation determines the form of the guarantee. In the case of the fixed loan, the guarantee secures the loan, and when the loan is repaid, the guarantors are relieved of their responsibility. In the case of the floating overdraft, the guarantee secures all advances from time to time on current account up to the agreed limit; that is to say, it is a continuing guarantee.

CHAPTER V

FINDING CAPITAL FOR THE ESTABLISHED BUSINESS —THE PRIVATE LIMITED COMPANY

In the previous chapters we have seen that it is usually best to finance a new business from one's own resources. Notwithstanding the increasing trend of industry towards trusts and combines and of the distributive trades towards amalgamations and multiple shop systems, there is as much room, as great opportunity, as ever for the new man with initiative and courage. What becomes more and more important is the direction that his initiative and courage take. It is yearly less profitable for the man with little capital to enter into competition with the combine, but mass production and mass distribution have definite limits. They cannot satisfy the whole of human needs; and even in the case of the needs they satisfy, they give rise to a host of subsidiary trades that are best left in the hands of the small firm. All great businesses have grown from small beginnings; to-day more judgment than ever must be exercised to foresee if the small beginnings are capable of development into the great business.

In many cases, however, the new business cannot be wholly financed from the resources of the founders, and we have examined the methods they usually adopt to find capital elsewhere.

Let us now assume that the business has been established for some time, that its possibilities are proved, and avenues for the profitable employment of further capital seen. At this stage it is often advisable to form a private limited company.

Private Limited Company. It is the great privilege and advantage of a limited company incorporated under the Companies Acts that the liability of the individual members for losses sustained by the company is limited to the amount, if any, unpaid on their shares. A company is a distinct being independent of the shareholders. The property of the company belongs to the company as such; it is not the property of the shareholders in common. Shareholders, therefore, differ from partners in a partnership in that they may make contracts with the company, and their goods cannot be seized for the debts of the company. A man applies for 100 shares of £1 each, the shares are duly allotted, and he subscribes £100 for them. The company may in the course of time become insolvent and be put into liquidation. Its assets will be realized and divided among the creditors; but our holder of 100 shares cannot be called on to help to pay these debts. He has paid £1 per share—the full nominal value—for 100 shares; and there ends his liability. Of course, if he had only paid 10s. per share, he would, in the event of liquidation, be required to contribute the balance of 10s. It is for this reason that banks and insurance companies often call up only a small proportion of the amount of their ordinary capital, and their balance sheets show, for example, £5 shares with 10s. paid. The balance of £4 10s. per share is of the nature of a reserve that can be called on in the event of some heavy and unexpected loss.

The advantages of the limited company to friends who are asked to help the business are great. If they subscribe capital they know the precise limit of their liability for losses, and the partition of the capital into shares provides a very convenient method of dividing profits. The share is not only a convenient unit, but it

is transferable. A member of a company, in case of need, may, without surrendering all of his holding, sell or assign a portion of it. If he wishes to make provision for his family, shares are easily transferred, and any suitable subdivision of a holding may be made. If he dies, the shares go to his heirs; if he becomes bankrupt they pass to his trustee. In neither case is there the dislocation that usually occurs on the death or bankruptcy of a partner in a partnership.

These remarks must, however, be qualified by the reminder that the transferability of shares in a private limited company is restricted. As its name implies, a private limited company is in theory composed of friends. The number of shareholders is confined to 50, exclusive of employees, past or present, and on no account may any invitation be made to the public to subscribe for shares, nor may any shares be offered for sale to the public. A director or the secretary of every private limited company is required, when making the annual return to the Registrar of Joint Stock Companies at Somerset House, to certify that in the course of the year just ended the number of members, exclusive of employees, has at no time exceeded 50, and that no invitation has been made to the public to subscribe for shares. The directors are given powers to ensure that the number of members is kept within the requisite limit. As a rule they are authorized to refuse to register a transfer of shares, and they need not give reasons for their refusal; but it is usually stipulated that, on the death of a member, his shares may go to his heirs, so long as the number of members is kept below 50.

It is important to note that the restriction of the number of members does not apply to employees, past or present. Profit-sharing with employees may most easily and advantageously be carried out where a

company exists. In many cases one of the main reasons for the conversion of a firm into a limited company is to give effect to a profit-sharing scheme. It opens up an avenue for fresh capital, and the business is consolidated by giving employees an interest in its success. The manager and others may well be willing to find capital to put in the business in order to obtain a shareholding in it, or they may be ready to allow part of their remuneration to remain in the company, so that at the end of a period they will receive the equivalent in shares.

The formalities to be observed at the time of the formation of a private limited company, and during the course of its existence, are lighter than in the case of a public company. The memorandum of association, defining the constitution of the company, and the articles of association, setting out the regulations that will govern it, must be drawn up, printed, and filed with the Registrar of Joint Stock Companies, together with a statement of nominal capital and a declaration of compliance with the requirements of the Companies Acts. On payment of the registration fees, the Registrar issues a certificate of incorporation, and the company may commence business forthwith.

Finding Capital for the Private Limited Company. We have in mind the conversion of a firm into a limited company so that new capital may be obtained with a view to the expansion of the business. In order that the friends whom we approach may know exactly what we are offering them, it is usual to draw up a memorandum embodying our proposals. We avoid the word "prospectus" in this connection. A prospectus is a circular sent out by the promoters of a public company to induçe the public to take shares in the company, and round the prospectus has gathered a great mass of

legislation to safeguard the public from unscrupulous or dishonest promoters. We may not appeal to the public for capital for our private company; we must find the money privately. Let us, therefore, avoid some possibilities of confusion at any rate by labelling our memorandum "Confidential Particulars of the Proposed Company," or words to that effect. As the particulars will form the basis of the contract under which our friends will engage to contribute capital, great care must be taken that every statement of fact in them is accurate, that no essential point is omitted, and that such estimates as appear are made on the soundest possible basis.

Particulars of the Proposed Company. There is no rigid form that the particulars must follow, but as a general rule they will show—

1. The capital of the proposed company, and details of the shares offered for subscription.

2. The board of directors as tentatively suggested, leaving one or two vacancies; and, perhaps, the names of the solicitors, auditors, and secretary.

3. The objects of the company.

4. History of the business that is being taken over by the company.

Statement of net assets to be taken over.

Statement of past profits.

The consideration paid to the vendors.

Estimates of future profits.

Management of the company.

5. Any contracts or liabilities not disclosed in the foregoing, made or incurred, or that will be made or incurred, by the company.

6. Form of application for shares.

The consideration of these particulars deserves a chapter to itself.

CHAPTER VI

PARTICULARS OF THE PRIVATE LIMITED COMPANY

Our first task is to make a careful estimate of the capital required by the company in view of the expansion of its activities that is anticipated as the result of the introduction of new funds. This estimate will follow the general lines suggested in our third chapter, but it can be drawn with a firmer hand, for it now is based on actual experience. The business has been running for some time; we can assess its capabilities, and we know where fresh capital can be most profitably employed.

The Capital Required. Of the total required, we are contributing the portion represented by the present business, or by so much of the assets of the present business as we are transferring to the company. It is, therefore, necessary for us to determine exactly what we are going to sell to the company, and to calculate the value thereof. We must remember that a limited company is a being independent of its members—a separate legal person; and in the case of the conversion of a firm into a limited company, even if the partners of the firm become the sole shareholders of the company, there must be a vending agreement, formal or informal, defining what the firm sells to the company. We need not necessarily make a complete transfer of assets and liabilities. There may be certain assets, say book debts, that we desire to retain. There may be certain liabilities which it is advisable for the partners to settle themselves. The values taken should be those shown in the audited balance sheet of the firm at the

date of the conversion, but it is usually best to have assets such as land, buildings, and plant valued by a licensed valuer. If we deduct from the total capital required the value of the net assets that we are bringing to the limited company, we obtain the amount of fresh capital which we desire to raise among our friends.

The Cost of the Capital. We now consider the price that we shall have to pay for this capital, or, in other words, the terms we shall offer so as to attract the capital of our friends to the company. As regards the form of our offer, we have at our disposal a number of alternatives. It is one of the advantages of a limited liability company that the capital is divided into various classes of shares, varying among themselves according to the risk which their holders take in the business. Broadly speaking, preference shares are entitled to a fixed dividend each year, while the ordinary shares receive the balance, if any, of the divisible profits. In the event of the winding up of the company, the holders of the preference shares have a lien on the assets prior to that of the holders of the ordinary shares. The rate of dividend on the preference shares may be cumulative, that is, if sufficient profit is not earned in any year to cover the full preference dividend, the deficit may be carried forward and paid in the next or succeeding years. The preference shares, besides being cumulative, may also participate, usually up to a fixed limit, in the profits after the ordinary shares have received an agreed dividend. Thus, we may have 7 per cent preference shares participating in profits *pro rata* with the ordinary shares up to 10 per cent, after the ordinary shares have received 7 per cent. There are a number of other forms—preferred ordinary shares, founders' shares, and so on—but they are merely variations of the classification which we have described.

In determining the form of our offer, there are three main considerations: first and foremost, the profit-earning capacity of the business and its prospects; secondly, the continuity or otherwise of the management; and, thirdly, the fact that, owing to the restriction of the right of transfer of shares in a private company, an investment in such a company is not easily realizable.

Profit-earning Capacity. The chief consideration is, of course, the profit-earning capacity of the business. We are not only selling to the limited company so much land, buildings, plant, machinery, stock, and so on; we are transferring to it a going concern which we have created in the past, which has had a success reflected in the profits earned, and which is capable of development and expansion. In the profit and loss accounts we have a solid basis at our hand for the calculation of its value, and we shall ask our auditor, or, if there has been no auditor, a reputable firm of accountants, to prepare for us a certificate of profits. The auditor will take the profit and loss accounts for a period of several years, usually five, or, if the business has not been in existence for five years, since the date of its commencement, and he will recast them so that he may obtain an average of such profits as the company may expect to earn. The usual adjustments necessary in recasting the accounts are as follows—

ITEMS TO BE ADDED TO PROFITS

1. Partners' salaries, interest on partners' capital and income tax. Interest on borrowed money, including loans, bank overdraft, etc.

2. Any exceptional losses, e.g. damages for breach of contract, loss through burglary not covered by insurance, etc.

3. Capital losses.

4. Any capital expenditure charged to revenue, e.g. cost of plant, machinery, furniture, etc., charged against profits in any year.

5. Any excessive reserves, e.g. for bad debts.

Items to be Deducted from Profits

1. Exceptional profits, e.g. on some contract, not in the usual way of business, unlikely to recur.

2. Capital profits on the sale of fixed assets, etc.

3. Income from assets which, under our scheme, are not to be taken over by the company.

In a word, we leave out of account profits, losses, and expenses that are of an exceptional or of a capital nature, or that will not recur when the business is taken over by a limited company. Interest on borrowed money, for example, will no longer figure among expenses when adequate working capital has been provided by the limited company.

The auditor will then give a certificate showing the average annual profit, and indicating with precision the basis on which it is calculated.

If it had been our purpose to sell the business to the company for cash, or partly for cash, and retire from the management, we should reckon the goodwill of the business at so many years' purchase of the average profits as above, according to the circumstances of the case and the nature of the business. The number of years' purchase would depend on a variety of considerations. A purchaser will weigh carefully such factors as the influence of the personality, now to be withdrawn, of the founders of the business, the length of time the business has been established, the extent to which it has acquired a monopoly or quasi-monopoly of custom—in other words, the nature of its connection

—its locality, the number and relative amount of transactions in a year, the extent to which it may be affected by legislation. As, however, in the case under review we merely contemplate finding additional capital for expansion, the amount of the average profits is important, not so much from the point of view of giving us the basis for the valuation of the goodwill, but as indicating the price we shall have to pay for the new capital.

Continuity of Management. The importance of continuity of management is self-evident. Unless in the case of outright purchase, the men who have built up the business will at least assist in the management of the company.

Disadvantages of Investment in a Private Limited Company. The third consideration to be borne in mind in formulating our offer is the relative disadvantage of an investment in a private company from the point of view of realizability. Owing to the limitations of the right of transfer of shares in a private company, these shares have certain definite drawbacks. If a shareholder wishes to dispose of them, he is faced with the difficulty, first, of finding a purchaser congenial to the company, and, secondly, of fixing the price of the shares. As there is no free market in them, it is usually left to the auditor to determine a price, but there is, of course, no certainty that this price can be obtained. Banks and kindred institutions, therefore, will not accept as security shares in private companies. It is of the essence of a security that it should be easily realizable in case of need, and an investor likes to feel that he can, if the necessity arises, deposit his shares with his bank as collateral for an advance.

The Offer of Capital. If our profits have been rising, and the average is large enough to give us a good return

and also cover a fair dividend on the fresh capital, we may think it sufficient to offer our friends preference shares carrying a substantial fixed dividend, say, of 7 per cent. But this is not enough. Our friends, for the reasons we have outlined, require more than a fair return on their money; they want to participate in the profits. The man who is content to-day with something under 5 per cent on Government Bonds will not look at 7 per cent or 8 per cent or, perhaps, even 10 per cent in a private company. His capital is being locked up for an indefinite period, and—well! he feels he should come in like the sleeping partner in a firm.

We decide, therefore, to offer our friends preference shares and a proportion of the ordinary shares. At this point it may occur to us that, as our friends will receive preference shares carrying a fixed dividend for the capital they subscribe, there is no reason why we should not receive preference shares up to the value of the assets which we are transferring. This would put the capital which we bring to the company on an equal footing as regards a fixed return with the capital which our friends subscribe. Let us, therefore, agree that the capital of the company shall be divided into preference shares, of which a part will be issued as fully paid to ourselves as vendors and the balance will be issued for cash to our friends, and into ordinary shares, to be divided in agreed proportion.

There is no necessity for ordinary shares to be of a considerable denomination. Ordinary shares receive the whole of the divisible profits after prior charges, including the preference dividends, are paid. It does not matter whether they are of a nominal value of 1s. each or £5 each. In the United States, indeed, the theory is carried to its logical conclusion by the many companies who issue their ordinary shares as having no

par value. This is not permitted under our Companies Acts, but in these days of high stamp duties, it is often advisable, especially in a case such as we are considering, to make the nominal value of the ordinary shares low. The proportions in which the ordinary shares will be divided must be arrived at on a balance of considerations.

Although in form we are selling our business to a limited company, in fact we are inviting our friends to join us in the development of a promising organization. It is our initiative and personality that have established the business, and it is mainly on our initiative and personality that the continued progress of the business depends. We are merely changing our designation from partners of a firm to directors of a company. We feel, therefore, that, while our friends should certainly receive a fair reward, the bulk of the ordinary shares ought to come to us. This may be very true, but our friends look at the matter differently. We have drawn attention to some of the disadvantages of an investment in a private company, and we have not exhausted the list. Our friends must be given a solid inducement in the way of ordinary shares before they will join us.

The circumstances of every case differ, but, for the sake of example, we might find a compromise on the following lines: Our business is a wholesale one, and we are transferring net assets valued at £6,000. Profits for the past five years have been rising steadily and show an average of £1,500 per annum. We require an additional £8,000 or so for expansion.

The capital of the company will be £15,000, divided into 14,000 7½ per cent cumulative preference shares of £1 each and 20,000 ordinary shares of 1s. each.

	£
14,000 7½ per cent preference shares of £1 each .	14,000
Of which 6,000 will be issued to the vendors fully paid	6,000
Leaving a balance of 8,000 for subscription .	£8,000
20,000 ordinary shares of 1s. each . . .	1,000
Of which 12,000 will be issued to the vendors fully paid	600
Leaving a balance of 8,000 for subscription .	£400

In this way our friends will subscribe for an equal number of preference and of ordinary shares, and they will receive two-fifths of the divisible profits after the preference dividends are paid. On the other hand, we receive preference shares to the value of the assets which we are handing over to the company, and we shall have the remaining three-fifths of the profits.

Constitution of the Board. Having determined the amount of capital required and how it is to be offered, the next point to be decided in drafting our particulars is the constitution of the board. The subscribers of the new capital will, as a matter of course, require representation on the board, and it is only human nature that in many cases they will desire a majority, directly or indirectly, in fact or potentially, thus giving them practical control, for they will point out that they are risking a greater amount of cash than we are. As we consider the business ours, we do not take the same view, but each instance will be solved on its merits. It will probably help us if we have in mind an acquaintance of some standing, whom we can approach to accept the chairmanship of the company. We all have our vanities, and it pleases most men to be asked to be chairman of a company. We shall, of course, see to it that our friend undertakes to subscribe for a certain number of the preference shares. In all financial

enterprises, from the largest to the smallest, it is of the greatest importance to secure a good lead, and with a chairman well known in our circle we have gone a good way towards winning the battle. In the Particulars we shall put down the name of the chairman and ourselves as managing directors, leaving, say, two places vacant for the nominees of the subscribers of the rest of the preference capital.

Management Salaries. We have made it clear, let us assume, that we shall continue to manage the company. We must now decide on the salary we require. The labourer is worthy of his hire, and as we are going to devote our whole time to the business—we may even be prepared to enter into a restrictive covenant to that effect—we ought to be remunerated. On the other hand, our salary should not be too large. We wish to show our friends that we look to our dividends and not to our salary to compensate us for our work. In fairness to all, we should compromise on the sum which, in view of our circumstances, may be considered a living wage.

Objects of the Company. A short paragraph is sufficient, but it should set out with precision the name and nature of the business taken over and how it is proposed to develop it.

Description. The history of the business from its commencement will be outlined, the certificate of profits shown, the assets to be taken over detailed, and the consideration to the vendors indicated. The use to which the new capital will be put should be elaborated, and estimates of future profits made. This is by far the largest section of the Particulars, and it is the one that will be read with keenest interest by our friends. While we shall naturally make the most of our business and its opportunities, we must remember, as we mentioned before, that the Particulars form the basis of

the contract under which our friends will subscribe capital. We must, therefore, be able to substantiate every statement contained in our memorandum.

Application Form. It is usual to append an application form for shares to the Particulars. We do not wish to evoke merely a vague interest in the minds of our friends. The application form places at their hand a method of giving concrete expression to their interest, while, coming as it does at the end, it is not unduly obtruded on their notice.

Distribution of the Particulars. When the Particulars are completed, we shall have a number duplicated and distributed among our friends. It must be emphasized again that on no account may we solicit capital from the public, firstly, because our company is a private one, and, secondly, because we want to avoid the formalities attendant on the issue of a prospectus. We have headed the Particulars "Strictly Private and Confidential," but it is a question of fact in each case whether we have restricted ourselves to friends or approached the public. The South of England Natural Gas Co., Ltd. (South of England Natural Gas Co., Ltd. (1911) 1 Ch. 573) thought that shareholders in other gas companies would be very interested in their scheme, and sent out 3,000 copies of their Particulars to selected shareholders in certain gas companies. The Court held that this was an invitation to the public. A gentleman interested in a certain company, when travelling from his home in the suburbs to his City office, distributed his Particulars to the people in the same railway compartment. This, again, was held to be an invitation to the public. If we do give our Particulars to anyone whom we do not know very well, we should ask the recipient to return the papers to us at once if he is not interested.

We have, of course, taken our accountant and our solicitor with us in drafting the Particulars, and they may help us very considerably by introducing us to prospective shareholders. If we number among our friends an insurance manager, a good stockbroker, or the director of an investment trust or issuing house, we shall find them useful. Officially, they can do nothing for us. An insurance company puts its surplus funds in realizable securities; the stockbroker is only interested in marketable shares; an investment trust looks askance at shares in a private company, and an issuing house, of course, cannot make an issue of such shares. On the other hand, these gentlemen are in touch with the investing public, and through them we may meet people who will be interested in our business. The same remarks apply to our bank manager.

We do not, of course, forget our customers and our trade suppliers; but we must be careful here, for they are apt to make their subscriptions dependent on conditions that may later prove irksome. Unless in exceptional cases—there are many instances in certain trades where large sums have been obtained from customers—it is better to obtain our capital from friends who have no special connection with our business.

Let us suppose that a number of friends are interested in our company. They will meet to discuss the Particulars, and they are sure to suggest alterations. We have named our solicitor and auditor as the solicitor and auditor of the company. Our friends may or may not agree to the retention of the auditor, but quite probably they will want a solicitor nominated by themselves to draft the memorandum and articles, and to be the solicitor of the company. If this demand is made, we shall give way, for there might be a conflict of interest if our solicitor acted for us and at the same time for the

company. The principal matters for discussion will, of course, be the proposed dividend on the preference shares, the amount of ordinary shares allocated to the new shareholders, the constitution of the Board, and the amount of our salary. We have considered these matters carefully when drafting the Particulars, and we shall come to an agreement with our friends, aided by our good sense and by the counsel of our professional advisers.

CHAPTER VII

DEBENTURES

A LIMITED company may find capital not only by the issue of shares, but, if it so desires, by the issue of debentures. Until the second half of last century the debenture was a document seldom used and of little importance. It might have been described as the form of IOU given by a company. In the Companies Act of 1862 no reference was made to it, but round about 1870 some ingenious lawyer devised the idea of the floating charge, and grafted it into the form of the debenture. No one knows who originated this peculiar form of security. It can only be said that between 1870 and 1880 the security of a floating charge by means of a debenture became familiar in the City of London and gradually spread through England. It is not found in any English conveyancing precedents published prior to 1870, and it was not formally recognized in company statutes until 1900. It is a simple form of security, but an extraordinarily effective one. We give a common form on page 46.

Included among the conditions referred to in paragraphs 1 and 4 as endorsed on the debenture are two very important ones. The first is to the effect that the loan secured by the debenture becomes immediately payable on the following contingencies—

1. If the company is, say, two months behind-hand in paying the interest on the debenture.

2. If an order is made by the Court, or if the company by an effective resolution decides, to wind up the company.

THE NONSUCH COMPANY LIMITED

ISSUE OF A DEBENTURE FOR £5,000

Carrying interest at the rate of £6 per cent per annum

Authorized by Resolution of the Directors dated the 31st day of December, 1930

DEBENTURE £5,000

1. The Nonsuch Company Limited (hereinafter called "the Company") will, on the 31st day of December, 1935, or such earlier day as the principal moneys hereby secured become payable in accordance with the Conditions endorsed hereon, pay to John Smith of 1 Fourth Street, Leeds, or other the registered holder for the time being hereof, the sum of £5,000.

2. The Company will, during the Continuance of this security pay to such registered holder interest on the said sum of £5,000 at the rate of 6 per cent per annum, by equal half-yearly payments on the 30th day of June and the 31st day of December in every year.

3. *The Company hereby charges with such payments its undertaking and all its property and assets, both present and future, including its uncalled capital for the time being.*

4. This Debenture is subject to and with the benefit of the Conditions endorsed hereon, which shall be deemed incorporated herewith.

Given under the Common Seal of the Company this 31st day of December, 1930.

The Common Seal of the
Nonsuch Company Limited
was hereto affixed in
the presence of

DAVID DAVIDSON, JOHN JOHNSON } *Directors.* Seal.

A. WRITER, *Secretary.*

3. If a distress or execution is enforced against any of the property of the company and not paid within, say, seven days.

4. If a receiver of the company is appointed.

5. If the company stops payment or ceases or threatens to cease to carry on its business.

The second condition empowers the debenture-holder, at any time after the loan has become payable as above, to appoint a "Receiver" of the undertaking, property, and assets of the company. This official is authorized to take possession of all the property and assets, to realize them, and to repay the loan secured by the debenture to the debenture-holder.

The Floating Charge. The essence of the modern debenture is the floating charge described in paragraph 3 of the example on page 46. It gives the debenture-holder the security not only of the whole assets of the company in its possession at the date of the debenture, but of all the assets thereafter coming into its possession from day to day and from year to year until the loan is repaid. When a debenture is issued, the company receiving the loan is at liberty to deal with its assets as it pleases in the ordinary course of business, but if it should fail to pay the interest on the loan, if it should get into difficulties, or even appear to be in difficulties, the debenture-holder may obtain the appointment of a receiver, who instantly takes possession of all the existing assets of the company to the exclusion of the ordinary creditors of the company. The Courts have likened the debenture-holder to a hawk, and at times the comparison is an apt one. He hovers over the company. If he considers that his security is in danger and the assets in jeopardy, he can swoop down and seize everything.

The conception of a floating charge is alien to the

law of Scotland and of the Continental countries. It certainly seems extraordinary that a company, by a simple document, can pledge its future assets. The person unlearned in the law is familiar with the not uncommon method of obtaining a loan against property by handing the property to, say, a pawnbroker. By a legal fiction, the completing of a debenture operates as if the whole property, present and future, of the borrowing company were put into the custody of the lender. The procedure in England is so easy. The directors pass a resolution authorizing the issue of the debenture, the company's solicitors prepare it—a simple task, for they can obtain a stock form from a stationer for a few pence—it is signed and sealed on behalf of the company, and registered at Somerset House.

Owing to the simplicity of the procedure and the overwhelming nature of the security, the limited company has, in the debenture with a floating charge, a means of attracting capital that is not available to a private individual or to a firm. With the exercise of ordinary precautions, the debenture-holder need run little risk, and a loan secured by a debenture is usually regarded as a safe investment. Armed with its latest balance sheet, a statement of its position, and a proposal to issue a debenture, a company has rarely much difficulty in finding a lender on reasonable terms. If the lender does not wish to trust only to the floating charge, the debenture can be associated with a mortgage of specific assets, such as land, machinery, or plant. The lender is made doubly secure in this way, for after the registration of the mortgage the company must obtain his consent before it can raise further moneys by mortgage, and a second mortgage would naturally rank after the first mortgage held by the debenture-holder.

The Bank Overdraft. The debenture is often used in connection with bank overdrafts. Expenditure must go before receipts, and when a company is doing well and expanding its business, it will often have to approach its bank for an overdraft on its current account. In granting an overdraft, a bank usually insists on the personal guarantee of the directors, to whom, in turn, the company may issue debentures by way of indemnity. In many cases the debentures are registered directly in favour of the bank. Indeed, in the last few years of industrial depression, when so many companies have had to be reconstructed, it has become quite a common practice to persuade large creditors to postpone their claims by accepting debentures.

Debentures and Credit. In the case of financial companies and the like, the issue of debentures is a usual way of obtaining capital at a low rate of interest, but an issue by a trading or manufacturing concern is often an indication that the company is in difficulties. This need not necessarily be so, but from the far-reaching nature of the instrument, finding capital by means of a debenture is in most cases resorted to when all other methods have failed. The registration of a debenture on a trading or manufacturing company has an immediate effect on its credit. The Registers at Somerset House are open to the public, and the trade papers keep a watchful eye on them in order to report the issue of all debentures that may affect their readers. The issue of a debenture does not in any way interfere with the company carrying on business as usual; but when a trade supplier knows that if the company's affairs go badly the debenture-holder may seize everything until the loan secured by the debenture is repaid in full, he is naturally chary of extending much credit to the company.

The Abuse of Debentures. Largely because the debenture is the result of trade usage, and has been little controlled by law, it is, unfortunately, subject to abuse. It has been condemned, in its present form, again and again, by lawyers, bankers, and business men, but hundreds of millions of pounds have been invested under it, and, in view of its enormous popularity, little has been done to control it. Almost an everyday occurrence, when a company is getting into difficulties, is for a favoured creditor—often a director—to be granted a debenture. The company will go on trading to the last moment, until some exasperated creditor obtains a judgment against it. The debenture-holder, so long as the debenture has been registered for three months, at once secures the appointment of a receiver and seizes the assets. The general body of creditors takes what is left after the debenture is paid off in full; in too many cases nothing is left for them.

Debenture Stock. When the position of a company is very strong—and this applies in particular to financial companies such as investment trusts, or to public undertakings such as railways—it is able, as we mentioned above, to obtain capital very cheaply by the issue of debentures. The period of such debentures is generally a long one; it may be fifty years or more. There are usually a large number of debenture-holders, and the procedure we have outlined is, therefore, modified a little. The loan to the company takes the form of debenture stock, usually issued in multiples of £50 or £100, trustees on behalf of the debenture stockholders are appointed, the debenture is associated with a trust deed on the property of the company, and the stock is repayable to the trustees. These are modifications only; the principle remains the same.

CHAPTER VIII

TRADE CONNECTIONS

In Chapter VI we suggested that the expanding business should, as a rule, refrain from seeking capital among trade connections because of the conditions and restrictions that accompany such help. There are many instances, however, where their financial aid may be profitably invoked, and the number of these instances is growing each year. In the chain between producer and consumer—grower, broker, manufacturer, dealer, retailer—there is always a strongest link, and it is in the interest of the strongest link to strengthen and gain some sort of control over the others. This is done by giving assistance at a price, and the assistance often takes the form of the provision of capital.

Securing Raw Materials. When a link near to the consumer gives assistance to one farther away, the purpose is, as a rule, to secure the supply of raw or other materials. In the new beet sugar industry in this country, the local factory makes advances to the farmer to enable him to buy his seed and grow his crop. The producer of wheat in Canada and Russia, of cotton in the United States and Egypt, of wool in Australia, receives similar assistance from the powerful collecting and marketing bodies. In most organized markets, indeed, it is one of the functions of the middleman to provide credit for the producer as and when required. In some cases the process goes beyond mere financing, and the middleman furnishes the producer with permanent capital, but usually this is the first step towards complete control. Take one of the big grocery combines.

It begins by acquiring an interest in ranches in Canada or tea plantations in Ceylon. It provides capital for development, but very soon the ranch or tea plantation loses its individuality and is merged in the combine. This process, which has been specially active since the War in almost all the great industrial and distributing combines, is worthy of special attention, but it is a little outside the scope of our present study.

Ensuring Markets. The reverse case, that is, where a link near the consumer receives help from one farther away, affects us more nearly. At the present time we are witnessing a struggle of ever-growing intensity for fresh markets. If the organization of production was the typical problem of the nineteenth century, the organization of markets may be said to be the typical problem of the twentieth century. Manufacturers and wholesale dealers must find outlets for their products, and those who can furnish these outlets are often in a position to obtain financial assistance at a fair price from their suppliers, not only by way of temporary credits, but in the form of permanent capital. The extent to which such assistance is given has reached great proportions, but the facts are not proclaimed from the housetops, and, as a rule, only those in close touch with any particular industry are aware of the degree to which it has prevailed in that industry.

The Tied House. Let us consider the tied house in the beer and spirits trade. The licensee undertakes to sell, for example, the beer of a certain brewery, and in return he is financed by the brewery. The extent of the capital provided and the conditions attached vary with circumstances. Cases are not unknown where the licensee has been given the premises, stock,, and adequate working capital against his simple undertaking

to sell the spirits or beer of the distillery or brewery concerned. In other instances the brewery advances a substantial proportion of the cost of the business and undertakes to pay rates and repairs, but it secures itself by a mortgage on the premises.

Retail Clothiers. The same process is carried a step farther by clothiers. When a retail firm in this trade has made a success of one or two shops, and is in a position to produce balance sheets showing good results, the partners will approach one of the manufacturers from whom they buy, and undertake to sell only his products if he in turn will provide them with capital by way of extended credit. They say to him: "We have dealt with you for some years, we have paid promptly, and our account is a growing one. You recognize us as good customers, and from our balance sheet you can see that we are doing well. We can do better if we open a new shop in such and such a district, but we can only open it if you will help us. This is our proposition. We owe you to-day £1,000. Let the £1,000 stand over, and supply us with more goods until our debt reaches £2,000. We shall open the new shop, contract with you to sell only your suits and overcoats, and three months after the debt reaches £2,000 we shall begin to make substantial payments on account." Let us suppose that the manufacturer agrees, that the new shop succeeds, and that the retailers pay on account, say, £400 per month, rising in time to £750. The more they pay the more they receive in goods to keep the debt at the £2,000 level. After a time they will come back to the manufacturer and suggest that, if the account be raised to £4,000 they will open another shop. And so it goes on. Some of the largest multiple shop concerns in this trade have been built up along these or similar lines.

Drapery Companies. In the bad times of the past few years many retail and small manufacturing drapery companies have been severely hit and have been saved from extinction by the financial help given by the large wholesale houses. This help takes many forms. At one extreme it has resulted in the complete control of the retail business, with the former owner reduced to the position of manager on behalf of the wholesaler. At the other extreme, the wholesale house has agreed to accept a moderate composition for its debt, and used its influence in persuading the other creditors to do likewise. Not an uncommon method has been for the wholesale house to guarantee a loan to the retailer. This is usually done, not through a bank but through an insurance company. The proprietor of the small business takes out a short-term life insurance policy for something more than the amount of the loan, and the insurance company makes him an advance which is guaranteed by the wholesale house and is repayable by instalments. The wholesale house often insists on the issue by the retailers of a debenture in security of the guarantee.

Other Examples. These are only a few instances selected at random, but the tendency is a general one. It may be seen in operation particularly in new and expanding trades such as the motor-car industry. In another sphere the manufacturer in the heavy engineering trades or the constructional engineer will give financial assistance to the general merchant in the colonies or abroad who through his agents may be able to influence orders. The firm of importers and exporters which can guarantee freight is assured of the ear of the great shipping companies when it approaches the latter for additional capital to cope with expanding business. The alert merchant, therefore, when considering methods of finding capital to develop his undertaking, should,

if he can guarantee a market, bear in mind the possibility of obtaining part at any rate of the capital he requires, from his trade suppliers.

Trade Credits. The provision of permanent capital in this way is a special case, but in every business, no matter what its nature, the amount and length of credit given by trade suppliers in ordinary day-to-day transactions are among the most important factors that determine the amount, or rather the effectiveness, of its working capital. An improvement in credit facilities is equivalent to the introduction of fresh working capital. We are not going too far when we state that the surest way the established business has of increasing its capital resources is to build up a reputation for ability and honest dealing, and so to improve its credit relations. Let us consider first a retail business. In the early stages credit is not easily forthcoming. When the new customer approaches the wholesale house for the first time, he must give his references. If the references are not very strong ones, the wholesale house will probably require him to make a deposit of £10 or £20, and for the first month or two his purchases are really for cash. As confidence is established, he receives a certain amount of credit that increases with time. If, on the other hand, the references are good, and a trade inquiry put through the usual channels is satisfactory, a credit limit is fixed to begin with at, say, £50 or £100. Every wholesale house prefers a great number of small accounts of a hundred pounds or so to a few large ones. The distribution of risk is obviously desirable. If the retail business wishes to increase its credit standing, the proprietors should themselves visit the wholesale house from time to time, and make the fullest disclosure of their business results and progress to the credit manager. Nothing inspires confidence with that hard-headed and

responsible official like a good balance sheet and profit and loss account, showing as compared with the previous ones a steadily expanding business.

Care should be taken that accounts are paid promptly and regularly. In many trades settling day is the twentieth of the month following delivery of the goods ordered. It is infinitely better to settle on the twentieth or even on the thirtieth of each month than to pay on the fifteenth of one month and on the twenty-fifth of the next. Regularity is as important as promptness. If the retail house keeps this principle in mind, is prudently managed, and takes the wholesale house into its confidence, it soons finds that its credit marking goes up, better terms are arranged, the extent of the credit is increased and its length, perhaps, extended.

The credit problem of the wholesale house, the importer and exporter, and the manufacturer, is in essentials similar, but it operates in a wider field. We get away from the monthly basis and meet with three to six months' credit, usually secured by bills of exchange. Credit standing may be judged by the extent to which the financial intermediary such as a bank is prepared to discount the bills accepted by the purchaser, and the rate of its charges for the service. These depend mainly on the financial resources of the purchaser and on the reputation he has built up. The most important factor again in increasing the amount of credit is a history of debts promptly and regularly met.

CHAPTER IX

BANKS

We have emphasized in previous chapters that in this country the banker does not conceive it as his function to furnish the permanent capital of a business, but that he is prepared to augment its working capital. In other words, he supplements the capital of a borrower; he does not provide it.

In Chapter III we indicated how the capital required by a new business is determined. It is divided into fixed capital and working capital. The former is the amount of money necessary to equip the business with plant, machinery, buildings, and other permanent assets; the latter is the outlay that must be incurred to maintain the business in running order. The estimate of the working capital required is always a difficult one to make. Are we to budget for periods of maximum activity or for periods of minimum activity? What are we to allow for the lag of receipts after payments? The business may start with £40,000 worth of plant, and apply £15,000 to the purchase of materials, payment of wages and other running expenses, before anything is ready for sale. We say that the fixed capital is £40,000, but is it accurate to state that the working capital required is £15,000 only? Receipts in a normal year may be £200,000 and payments £190,000, leaving a profit of £10,000. If receipts and payments accrued regularly from week to week and month to month, if the volume of production remained constant throughout the year, if unforeseen contingencies never arose, we should be justified in taking the working capital at

£15,000. But we live in an imperfect world. Of the goods sold for £200,000, £150,000 worth may be produced in the winter season, and only £50,000 worth in the summer season. At the time of peak activity an amount of capital far in excess of £15,000 will be required to finance the purchase of raw materials and the payment of wages. Again, it is only in rare instances that from week to week throughout the year current expenditure can be met from current revenue. What is much more likely to happen is that three months' credit must be given on sales, while only one month's credit is received on purchases. Unforeseen contingencies, even in the best regulated businesses, are apt to happen. There may be a strike, or a loss not covered by insurance, or a host of other things. What is the business man to do, then, in estimating the working capital he has to raise? It would obviously be injudicious if he were to find by way of shares or permanent loan a sum sufficient to meet the maximum demands that the business might make for cash at its busiest times. In the quiet seasons there would be funds lying idle, or at the best earning a low rate of interest on deposit at a bank. It would also be a serious matter if he were to include in his capital estimates a sum sufficient to provide for all contingencies as his only alternative to a forced realization of stock if the contingencies arose. He solves the problem simply, by estimating, as the working capital that the business should provide, the outlay that must be incurred between the commencement of production and the sale of the product in accordance with the plan on which operations are to be carried out in the first year; he allows a little bit over, and relies on his bank for the rest. In the case we have considered he therefore would be justified if he raised by way of shares a little over

£55,000, of which £40,000 would be fixed capital, and the balance he would call his working capital. The function of the bank is to augment this working capital by bridging the gap between receipts and payments, and by temporary lending in cases of seasonal activity or to meet contingencies. Broadly speaking, those two services find expression in the two methods by which a bank lends money, namely, by discounting bills of exchange, and by making advances in the form of loan or overdraft.

Discounting of Bills of Exchange. The discounting of bills of exchange is one of the best ways in which a banker can employ his funds. His assets must be liquid. They may not be tied up in long term obligations, for his liabilities consist mainly of demand obligations which he may be called on to meet at any time in cash. A bill of exchange is really an anticipated receipt for goods sold, endowed by law with certain properties that make it capable of forming an ideal security. Our trader requires cash for his productive or trading operations, but he has to sell his goods on long credit terms. He draws a bill of exchange on the buyer of the goods, the latter writes across the bill that he accepts it, and he then returns it to the seller. The seller takes the accepted bill to his bank, and the bank discounts it; that is, it provides the trader at once with funds which he can employ in his business, and when the bill falls due, the banker collects the debt and repays himself the amount he has advanced.

How does the banker determine whether or not to discount a bill? He does so by estimating the value of the names appearing on the bill. Of first consideration, of course, is the standing of the acceptor, for he it is who will meet the bill on maturity; but the drawer and endorsers, if any, are hardly less important, for

the banker has an equal right of recourse against them in case of default by the acceptor. Let us suppose that the trader has an order for £100,000 worth of agricultural machinery from a firm in the Argentine, delivery to be spread over six months, and payment to be made by bills accepted payable three months after sight. The trader at once goes to his banker, and inquires, firstly, if he will discount the bills, and, secondly, at what rate he will discount them. The banker will take up the bank references, in this country if possible, of the Argentine firm, and after considering its standing as well as the standing of his customer, will give his decision. The banks have a remarkable intelligence system, and they give each other in confidence particulars of the credit standing of their customers. There are also organizations, such as Seyd & Co., in close touch with the banks, that make a speciality of assessing credit standing. Since the War, too, there has grown up a form of insurance known as credit insurance, which is specially valuable in this connection. If a trader is dealing with a new customer whose credit standing is not well established, and whose bills the bank is reluctant to discount, he is able to insure the credit either in whole or in part. With the risk thus covered by a respectable insurance company, the bank hesitates no longer in discounting the bill.

Banks rarely discount a bill of more than six months. The favourite bill is the three months' bill.

Instead of lending money by way of discounting a bill, a bank sometimes lends its name. A large proportion of the export trade of this country is financed by means of bills accepted by the London merchant bankers and acceptance houses. The banker consents up to an agreed limit to accept bills drawn on him by the exporter. When the goods are ready for shipment,

the bills of lading and other documents relating to the goods, together with the bills of exchange, are handed to the banker. He accepts the bills of exchange, returns them to the exporter—who, of course, has no difficulty in discounting them at once—and sends the shipping documents to his correspondent in the country to which the goods are consigned. The correspondent collects the sale price from the foreign buyer and remits it to the banker, who is thereby placed in funds to meet the bills he has accepted when they fall due.

Advances by Way of Loan or Overdraft. The bulk of the money that a bank lends is advanced in the form of loan or overdraft. We have already (Chapter IV) discussed the difference between these two methods of accommodation. When business is exceptionally brisk, at a time of seasonal activity for instance, the trader or manufacturer finds that his working capital is fully occupied. His bank balance dwindles to zero, and still he must find means of buying more and more goods. In his need he turns to his banker for an advance.

Advances may be secured or unsecured. In either case the banker, before granting the accommodation, is influenced by the following considerations—

1. The reputation of the borrower, and his record as a customer of the bank.
2. The amount of capital employed in the business.
3. The purpose of advance.
4. The means of repayment.
5. The state of trade.

It might be thought that where ample security is offered to the banker, there should be no necessity for him to make some of those inquiries, but it should be borne in mind that a banker seldom makes an advance,

even on the strongest security, if at the time of making the advance he has any reason to believe that he will require to realize the security in order to repay the loan.

Nevertheless, when application is made for a loan, the banker's first inquiry is: "What security have you to offer?" The security may be the guarantee of a third party, the deposit of stocks and shares, of life insurance policies, debentures, or goods. The last-named is very usual, for instance, in the case of raw materials, colonial produce, and the like handled by brokers, traders, and manufacturers. The trader holds stocks that are not immediately saleable. He puts them under the control of his banker, and obtains an advance of 60 per cent to 90 per cent of their value. As he requires any part of the goods pledged in this way, he repays the proportionate amount of the advance in respect of the quantity released.

When no security is offered, the five considerations we have mentioned are examined very carefully in the light of the borrower's balance sheet. The weight given to the various items in the balance sheet and their relative importance from the banker's point of view form a subject of the greatest interest, but its consideration would require many chapters. Suffice it to say that, if the business is judged to be a sound one, if it has been a good customer of the bank in the past, and if the demand for an advance is to cope with a seasonal fluctuation in trade or to meet some contingency, an unsecured advance may quite probably be obtained.

CHAPTER X

FROM THE PUBLIC—THE ISSUING HOUSE

In Chapters II to IV we dealt with the problem of finding capital for a new business, and in Chapters V to IX with the provision of additional capital for the smaller type of established business. In both cases the appeal was of necessity confined to a comparatively small circle—to friends, to trade and financial connections. We now approach the larger question of obtaining capital from the public.

First of all we shall consider the methods employed to this end by the public limited company. It has been noted that the normal progression is from one-man business or partnership to private limited company, and from private limited company to public limited company. The private company may find its business expanding so rapidly that it is unable wholly to finance the new developments, or for family reasons the owners may desire to be relieved of part of their responsibilities and, at the same time, to make some money by throwing their business open to the public. Someone must take the initiative in the matter. It may be the principal owners of the old business, or a syndicate specially formed for the purpose. We call them the "promoters." The old business is sold to them or to their nominees, a public company is formed, and they resell the business to the new company. From this point of view they are the "vendors."

The general principles that we have discussed in relation, for instance, to determining the amount of capital required, the form of the offer and so on, apply

with even greater force when the appeal for capital is made to the public. There is, however, one essential difference between the private and the public appeal. Friends and connections have every opportunity to investigate the position of the concern for which they are asked to provide capital; but the public must rely on the prospectus, that is, the published statement inviting subscriptions to the loan or to the issue of share capital. Since the days of the South Sea Bubble there have been unscrupulous promoters who have fleeced the public in the process of enriching themselves, and bitter experience has compelled the legislature to lay down very stringent rules to regulate the manner and the matter of the appeal to the public. The reader will find these regulations conveniently summarized in the Fourth Schedule to the Companies Act, 1929.

Until the passing of the Companies Act, 1929, the public company raising capital by way of an issue of debentures or debenture stock, and foreign and colonial corporations making issues of capital in England, escaped these obligations. The new Act brings all such issues under the same rules and regulations, with a few modifications, as govern English companies making an issue of shares. It was always an anomaly that debenture issues should be on a different footing from share issues, and the new uniformity of practice is welcomed. No honest foreign or colonial corporation can take exception to the application to their issues in this country of the conditions that regulate home issues; for these conditions, though stringent, are admittedly reasonable and just. The change in the law is a boon to the investor; he is at last given the same information and protection as regards foreign issues that he has always had at home.

Loans on behalf of foreign Governments and of home

or foreign municipalities are not, however, compelled to give the prospectus details required by the Companies Act, 1929.

In this and the following two chapters we shall discuss the offer of shares by our own joint-stock companies, and we shall look at other types of prospectus in Chapters XIII and XIV.

Apart from the statutory rules, there has grown up, as one would expect, a strong body of custom relating to the appeal to investors; or rather we should say that the 1929 Act gives the force of law to a part only of the accepted practice in dealing with the issue of shares to the public. But the individual or the institution that transgresses the unwritten laws, or departs from the "usage of the trade," fares badly. A proper understanding of the part played by the prospectus is dependent on an appreciation of these "laws"; so before discussing the provisions of the prospectus proper we shall consider the most important of them.

They may be summarized as follows—

An issue must be made by a recognized issuing house.

The issue should, as a rule, be underwritten.

The prospectus should state that application for official quotation of the shares will be made to one or more Stock Exchanges.

A recognized firm or firms of stockbrokers should be appointed as brokers to the company.

Application moneys should be paid to the bankers of the company, and not to the company direct.

The valuation of assets should be made by experts.

The Issuing House. The issuing houses are the recognized part of our financial system that exists for the purpose of obtaining new capital from the public. They are the pipe-line between the pockets of investors all over the country and the public companies looking for

capital. Almost invariably they combine this with other functions. They may be merchant bankers or financial agents for a group of trading or industrial concerns, or finance companies doing investment business, specialized or unspecialized; but no matter what their other functions may be, they are looked on first and foremost by the City as issuing houses.

It is a thousand pities that in most prospectuses the name of the issuing house is kept so modestly in the background; one has to look carefully for it. At the theatre or the cinema the name of the producer is thrust before our eyes. To find the name of the "producer" of an issue we have usually to search the small type at the bottom of the prospectus relating to contracts, and in particular to underwriting contracts.

The all-important asset of an issuing house is its good name. The higher its prestige the more it can pick and choose among the companies competing for capital, and the greater the ease with which it obtains money from the public. It need then only handle the best, and the public soon recognizes this. When underwriters and the better-informed section of the public see a prospectus, the first thing they look for is the name of the issuing house; and the reputation of some is so high that they are followed almost blindly. It is not going too far to say that the status of the issue is determined by the status of the issuing house. The limited company seeking capital from the public should, therefore, make it a matter of primary concern that it only approaches issuing houses of first-class reputation to act as intermediary. In the boom period of 1927–28 many financial companies of small capital, of doubtful antecedents, or of recent creation, set up as issuing houses. The past few years have seen hundreds of the companies brought out by these houses go into

compulsory liquidation, with a consequent loss of capital of some hundreds of millions of pounds to British investors. The bitter experience of these years and the more stringent provisions of the Companies Act, 1929, have, it is hoped, taught their lesson, both to the public company seeking capital and to the investor.

When the issuing house is approached, the proposition is examined from a number of points of view—

1. Who are the directors?—the personal element coming out again.

2. Does the history of the company and its past record of profits justify the proposed issue?

3. Is it reasonably sure that the new capital can be profitably employed and that it will yield a good return?

4. Is it the type of issue that will appeal at the moment to the investing public?

1. The Board

The constitution of the board is an important matter, for on the management will largely depend the future success of the company. Continuity of management is necessary. It is only in a most exceptional case that an issuing house will consider for a moment an issue where the previous owners of the business, if they were actively engaged in the management, propose to retire. It is a different matter, of course, where the owners of the capital did not take part in the management; the retention of the actual managers is then sufficient.

Most old-established companies have a board consisting of members of the family of the founders of the business and a few of the more important employees. These gentlemen have been in the business all their lives; they know it from top to bottom; but their names do not carry weight with the public. It is usually essential, or at any rate advisable, for the promoters to add

to the board one or two names that are widely known. In these days this does not necessarily mean persons of rank. The day of the "guinea-pig" is over. The people to approach are, if possible, men who have made a success of some allied type of business, or who have acquired a national reputation for probity or organizing capacity. If the new director or directors can influence business for the company, so much the better. If the reconstruction of the board has not been done before approaching the issuing house, the latter will in all probability suggest it. Sometimes the issuing house will require a nominee of its own to be elected to the board. It has a certain duty to the public, and, if it is not quite satisfied with the board, it may insist on the appointment of one of its own men.

2. History of the Company and its Past Record of Profits

Almost the first question that the managing director of the issuing house asks is—"What have the profits been?" If this question cannot be answered satisfactorily, he will show his caller to the door without further ado; if the answer is satisfactory, he will examine the credentials of the person or persons who have certified the accounts. Even if these are the professional accountants who have been auditors of the company, he may, for prospectus purposes, in the case of the large issue at any rate, require some widely-known firm of accountants to make an additional examination of the figures so as to join in the certificate. Such is the advertising value of a name!

3. Safety of Capital and Probable Yield

The first point is the net value of the assets that are being bought by the new company from the vendors.

The issuing house will require a valuation to be made by a well-known firm of valuers, and if it is a good issuing house it will see that in the prospectus the certificate sets out the chief items in detail.

An expert can value easily enough the tangible assets, such as land, buildings, plant, machinery, book debts, etc., but difficulties arise when we come to the question of goodwill. We have indicated in a previous chapter the bases usually adopted in calculating goodwill; but the issuing house must look at it from the point of view of "What will the public stand?" Much depends on the form that the offer to the public takes. The owners of the old business usually want a considerable proportion of the purchase price in cash. The proportion of cash to shares in the new company requires careful adjustment. If they take too much in cash, the public will consider that they show a lack of confidence in the business.

Some people think that if the owners of the business take too much in shares, the public may not relish the idea of their consequent control of the management; but this is an over-statement. It is the greatest sign of complete confidence in the business if they take the whole purchase consideration in shares, leaving the capital subscribed by the public to be used wholly as additional working capital. On the other hand, the promoters, or, for that matter, the issuing house, must not "skim the cream" off the business by unloading on the public a large amount of fixed interest-bearing capital and retaining for themselves the shares, call them ordinary, deferred, or what you will, that carry the bulk of the profits. In these cases the public really bears the major portion of the risk, and gets very little for it. It is greatly to the credit of the City that it sets its face against any attempt to make this a practice.

In the spring of 1928 one of our greatest issuing houses, in conjunction with a well-known firm of stockbrokers, made a large issue of 7½ per cent preference shares and 6½ per cent debentures, while retaining all the ordinary shares for themselves. The market generally felt that, notwithstanding the excellent auspices under which the issue was made, it was not fair to the general public. The issue was a failure, the underwriters were left with the great bulk of it on their hands, the market did not help them to unload, and both debentures and preference shares, though intrinsically they may be sound enough, have stood ever since at a heavy discount.

For much the same reasons, there is a growing hostility to the practice of issuing 1s. ordinary shares. In the case of the private company, where the motive is usually to avoid paying heavy stamp duties, the practice is sound enough; but in public companies it has usually been found to be only a convenient way for the promoters to get away with the lion's share of the profits.

4. The Psychology of the Investing Public

Much depends on the temper of the public at the time the issue is made. There are fashions in shares. Money is more plentiful at some times than at others. In the spring of 1928, for example, markets were rising, there was a speculative fever abroad, and industrial issues were booming. Gramophones, artificial silk, plate glass, and cinema films were favourites; any company dealing in these products was assured of a favourable reception. The demand for such issues was so great that the issuing houses found difficulty in obtaining a sufficiency of them. This was the psychological moment, therefore, for any such company to sell out to the public on most favourable terms. The result was that

many new concerns sprang up in the night. Most of them were highly speculative enterprises. Any new patent or process in the manufacture of plate glass or gramophone records was eagerly seized on, a company was formed, and the promoters reaped handsome profits. It is now a matter of history that the promoters in most cases were the only people connected with these companies that did make profits.

On the other hand, the spring of 1928 was a bad time for, say, a mining flotation. The public was not then interested in mining. There were many mining enterprises requiring money, but when they approached the issuing houses they were advised to wait with what patience they might until the tide turned. In such cases, however, there is often an alternative. There are specialized financial houses always on the look-out, to take a few examples, for oil, mining, or plantation propositions. If the times are not propitious for a public issue, but the concerns are in urgent need of capital, the owners may be able to make quite a good bargain with one or other of these houses. The property is then either amalgamated with other properties under the same control, or it is put into cold storage, so to speak, until the temper of the public changes and an issue on favourable terms can be arranged, with, of course, corresponding profits to the intermediary. It is a matter of interest that, notwithstanding the speculative nature of all mining enterprises, mining issues are in as good hands as any; the financial houses specializing in this type of business are sufficiently powerful and organized to keep intruders out of the field.

CHAPTER XI

FROM THE PUBLIC (*cont.*)—UNDERWRITING—APPLICATION FOR OFFICIAL QUOTATION ON THE STOCK EXCHANGE

No matter how carefully an issue of capital is prepared, no matter how sound the issue appears in the eyes of the promoters, it does not necessarily follow that the public will subscribe for the whole of the shares offered. The issuing house and the promoters may have misjudged the temper of the investing public; the offer may not appeal to them. In the short interval, too, between the decision to make the issue and the actual offer to the public much may happen. A financial scandal, a Press campaign, an increase in the Bank rate, a sudden tightness in the money market, a revolution in South America, an earthquake in Japan, a thousand and one events may occur to unsettle prospective investors sufficiently, on the morning the prospectuses appear, to prevent them from sending in their cheques and application forms. It is therefore a matter of primary importance to all concerned with an issue to insure against the risk of the public failing to subscribe the capital offered. This insurance is effected by having the issue underwritten. The underwriters, for a commission, guarantee that, if the public does not subscribe the full issue, they will make up the difference, so that the company will receive the full amount of the capital offered. In short, underwriters guarantee the issue.

The issuing house, in conjunction with the brokers to the offer, usually makes itself responsible for the

underwriting. It enters into an underwriting contract, called the "Main Underwriting Agreement," with the company and distributes its risk among its following, much as an insurance company re-insures a proportion of a risk among its associates. The issuing house is in touch with stockbrokers, banks, financial houses, underwriting syndicates, and others who are on its books as willing to follow its lead and bear a share of the risk of the issues that it thinks fit to make. These are the sub-underwriters.

Commission. The usual wording in a prospectus is that the issue has been underwritten by an issuing house for a commission of, say, 3 per cent, and an over-riding commission of 1 per cent. The over-riding commission is the remuneration of the issuing house for its responsibility and trouble in the matter; the 3 per cent is passed on wholly or in part to the sub-underwriters.

The amount of commission to be paid depends, naturally, on the prospects of success that it is judged the issue will have. The short description of the underwriting contracts, given usually in small type at the end of the prospectus, is one of the most illuminating parts of that document. The rate of commission and the standing of the underwriters is at once an index of the nature of the issue, and throws valuable light on what may be called its status. As a rough guide, it may be said that, when the underwriting commission is 5 per cent or over, the issue is a speculative one and should be watched carefully.

Underwriting is a plant of modern growth. Although towards the close of the nineteenth century it was apparent that underwriting had become an essential part of the machinery of the money market, it was not until the passing of the Companies Act, 1900, that it

was given legal sanction. Until then it had been a "hole-in-the-corner" business. The Act of 1900, however, permitted a company, prior to offering shares for public subscription, to contract direct with underwriters; but it stipulated that the contract with the underwriters, as a material contract, should be disclosed in the prospectus. The position envisaged was that the underwriters were principals, and as such guaranteed the issue.

The Main Underwriting Agreement. Until 1920 this, broadly, was true. The main underwriting agreement, after setting out particulars of the issue, and stating that the guarantors were willing, and had offered, to underwrite the subscription of the shares at par, proceeded to state the conditions of the contract. The guarantors undertook, before the first day fixed by the prospectus for the opening of the subscription list, to hand to the company irrevocable applications by themselves, or by sub-underwriters approved by the company, for the whole of the shares offered, together with a cheque or cheques for the application money payable in respect of the shares. If the public subscribed in full for the shares offered, the cheque or cheques of the guarantors, or their sub-underwriters, were to be returned. If, however, the shares offered were not fully subscribed by the public, the guarantors agreed that those not applied for should be allotted to them or to their sub-underwriters. Finally, the agreement stated that the company should pay commission in respect of the shares guaranteed, such commission to be paid within a short time—usually fourteen days —after allotment of the shares offered for subscription, *provided that all sums payable on application and allotment in respect of the said shares had been previously paid to the company.*

The Sub-underwriting Agreement. The sub-underwriting agreement entered into between the guarantors and their sub-underwriters usually ran, and runs, somewhat as follows—

A. B. & Co., Limited

Capital £800,000

divided into

500,000 Ordinary Shares of £1 each.

300,000 7% Cumulative Preference Shares of £1 each.

Issue at Par

of

300,000 Ordinary Shares of £1 each.

Sub-underwriting Letter

To Messrs. C. D. & Co.

Dear Sirs,

Whereas you are proposing to guarantee the subscription of the above 300,000 Ordinary Shares, I/we the undersigned hereby undertake and agree with you as follows—

1. I/we hereby underwrite of such Ordinary Shares and I/we hand you herewith an application for Ordinary Shares, together with a cheque for £ , being per share payable on application for such Ordinary Shares. Any blanks in such applications may be filled up by you.

2. In the event of the 300,000 Ordinary Shares not being fully applied for by the public (excluding subscriptions withdrawn before allotment and/or subscriptions rejected by the Directors as unsatisfactory) I/we will accept and pay the amount payable on allotment and the subsequent instalments as provided by the Prospectus offering the Shares for subscription upon such number of Ordinary Shares as shall represent my/our proportion *pro rata* with other underwriters of the total number of shares not applied for by and allotted to the public, it being understood that all *bona fide* applications by the public shall be allotted in full before I/we and other underwriters are required to take any shares. Shares allotted to any underwriter/underwriters in respect of any firm application by him/them are to be applied in relief *pro tanto* of his/their underwriting.

3. This agreement and the said application are to be irrevocable on my/our part.

4. The Prospectus offering the shares for subscription shall be in the form of the proof dated the day of 193 , with such alterations as you may approve, and the time of issue of the Prospectus shall be such as you may determine, but neither party is to be bound by this agreement if such Prospectus is not advertised on or before the day of 193 .

5. I/we will not sell or offer to sell any of the Shares until after the first general allotment made under the said Prospectus.

6. In consideration of this Agreement you are to pay me/us a commission at the rate of 3 per cent upon the amount of Ordinary Shares underwritten by me/us, such commission to be paid within fourteen days after the first general allotment under the said Prospectus provided all moneys (if any) due from me/us on allotment have been duly paid.

7. I/we would like to take firm of the Ordinary Shares underwritten by me/us.

Yours faithfully,

(Signed) E. F.

Address:

Date: 193 .

ACCEPTANCE

To E. F., Esq.

Date: 193 .

We beg to acknowledge receipt of your letter, dated the day of 193 , and agree to the terms thereof, and in underwriting the above 300,000 Ordinary Shares shall do so relying on your letter.

We note your desire to take shares firm and will put it forward.

Yours truly,

C. D. & Co.

With underwriting and sub-underwriting agreements such as the above it is obvious that the main underwriters are principals and guarantee the issue. If they are financially sound, the insurance is complete, and the protection given to the investor by the stipulation in the Companies Acts that particulars of the

main underwriting agreement should be printed in the prospectus is adequate. In practice, however, during the last ten years the main underwriters have, through contracting out their obligations to the sub-underwriters, become less and less principals and more and more of the nature of brokers.

Abuse of the System. There has been a gradual deterioration in the provisions of the main underwriting agreement, and this more than anything else gave rise to the scandalous state of affairs seen in the aftermath of the 1928 boom. The first stage in the deterioration made its appearance about 1920. In the typical main underwriting agreement outlined above the underwriting commission was only to be paid provided that all sums payable on application and allotment in respect of the shares had been previously received by the company. In 1920, however, underwriters began to insist that the commission should be paid within fourteen days after allotment of the shares offered for subscription, whether or not the company had received the moneys due on application and allotment. In this way, if the company approved the sub-underwriters, but some of them failed to meet their obligations, the full commission was, nevertheless, payable to the guarantors.

In a few years this trend had been carried much farther, until a paragraph something like the following began to make its appearance in main underwriting agreements—

> The underwriters will upon the opening of the subscription list hand to the company or its bankers applications by sub-underwriters at par for the shares, together with a cheque or cheques for the deposit of per share payable in respect of such shares. Such underwriters' applications shall be to the satisfaction of the Directors of the company or their representatives, and when the Directors

of the company shall have considered and approved such sub-underwriting to the full amount of shares the underwriters shall be *relieved of their guarantee in respect thereof.*

In this way the main underwriters passed on the whole of their obligations to the sub-underwriters, and the door was wide open for the abuses of the practice that soon followed. In 1929 seldom a day passed in which the financial Press did not report strong comments by the Court or by the Board of Trade on the collapse of companies caused directly through the failure of sub-underwriters to meet their obligations. It is common knowledge that main underwriting contracts were often made with syndicates having only a nominal capital, and that the sub-underwriters to whom they contracted out their obligations were men of straw. In the result, the protection apparently given to the company issuing shares and to the investing public by the statutory obligation to publish the particulars of the main underwriting agreement in the prospectus had little basis in reality; the whole thing was a sham.

For the sake of the good name of the City of London strong measures will have to be taken to ensure the validity of underwriting contracts. Some eminent firms of solicitors are letting it be known that they will not act in any issue where the main underwriting contract is made with a company having a paid-up capital of less than £50,000. The Committee of the London Stock Exchange have also passed a rule, in the case of any new company applying for a quotation for its shares on the Stock Exchange, that the applying company must submit full particulars of the capital etc., of any company acting as principal underwriter. These are steps in the right direction, but the main solution of the problem will be found by restoring to the

main underwriting contract its function as a *guaranteeing contract*, and by preventing main underwriters from contracting out the whole of their obligations.

Application for Official Quotation on the Stock Exchange. We have seen the importance of the issuing house as providing a channel for the gathering of capital; but it is no less essential, in making an issue, to provide for the ready marketing of the shares after they have been issued. The importance of a "free market" cannot be over-estimated. When an investor applies for shares he does so in the hope that by coming in on the "ground floor" he will obtain a good yield on his money and see his investment gradually appreciate in value. In either case he must know that he is able at any time to sell his shares in the open market.

It is for this reason that an official broker or brokers for the company are appointed. These gentlemen make it their business, particularly in the early days of the new concern, to look after the market—if necessary, to "make" a market in the shares. From this point of view, too, it will be appreciated that the importance of underwriting an issue lies not only in securing full subscription of the capital but in interesting prominent financial circles in the issue so as to ensure its popularity in the market. Great industrial and financial undertakings, even foreign governments of unimpeachable credit, have their issues underwritten, although everyone is aware that the issues will be many times oversubscribed. In such cases the provision of a market by the judicious placing of the underwriting is the real reason for the underwriting contracts.

When the investor sees at the top of the prospectus that application will be made in due course to the Committees of certain Stock Exchanges for an official

quotation of the shares offered, he, on his side, is reassured, for he knows that, before a Stock Exchange will "list" the shares, certain onerous regulations must have been observed. Listing implies, for instance, that the prospectus has been properly advertised, that at least one-half of the nominal capital has been offered for subscription, that at least two-thirds of the nominal capital issued has been applied for and has been unconditionally allotted to the public, and that shares issued to vendors in part or full satisfaction of the purchase price of the business cannot be dealt in for six months after the official quotation for the same class of shares subscribed by the public has been obtained.

CHAPTER XII

FROM THE PUBLIC (*cont.*)—THE SHARE PROSPECTUS

Now that we have examined, in however brief a fashion, the current practice in making an issue of shares, we are in a position to appreciate the part played by the prospectus. Our discussion of the statutory contents thereof must necessarily be short, and the reader would be well advised, in considering it, to have an actual prospectus before him. He will spend an interesting half-hour in seeing whether, and if so, how, the statutory provisions have been complied with. If he is one of the fortunate people who do not receive prospectuses by every other post, all he need do to obtain one is to look at the City page of his morning newspaper. He is sure to see there the advertisement of a prospectus. If the prospectus is not given there in full he should note the name of the company's bankers, and go to the nearest branch of these bankers, where he will find a copy of the prospectus lying on the counter. One or other of the "Big Five" are usually named as bankers of the issue. Before allowing their names to be so advertised, they, of course, examine the draft prospectus submitted to them very carefully, and satisfy themselves as to the *bona fides* of the issue. Their branches all over the country are, as a rule, supplied with copies, the application forms are marked, and the bank receives a brokerage in respect of accepted applications made on the marked forms.

Definition. The prospectus is defined by Sect. 380 of the Companies Act, 1929, as any "notice, circular, advertisement, or other invitation, offering to the

public for subscription or purchase any shares or debentures of a company." The object of the promoter is to make the prospectus as attractive as possible; the object of the legislature is to prevent the public from being misled. The statutory provisions attempt to ensure that there shall be the fullest possible disclosure of the nature of the offer, and of the profits that promoters, vendors, directors, brokers, and underwriters will reap from it. The public ought to know, in the first place, what it is putting its money into, and, in the second place, how the money will be spent.

Filing of the Prospectus. The prospectus must be dated, and a copy, signed by each director or proposed director, is filed with the Registrar of Joint-stock Companies. The prospectus must state on the face of it that a copy has been so filed.

Statutory Contents of the Share Prospectus. The particulars that require to be shown in the prospectus are set out in the Fourth Schedule to the Companies Act of 1929. Every prospectus must state—

1. *The contents of the Memorandum of Association of the company with the names, description, and addresses of the signatories of the Memorandum and the number of shares each has subscribed.*

The Memorandum gives the objects of the company and the amount of its nominal capital.

2. *The number of founders' or management or deferred shares, if any, and the nature and extent of the interest of the holders in the profits and property of the company.*

The number and nature of the deferred shares show at a glance the proportion of the profits of the company that will not be available to the public.

3. *The number of shares, if any, fixed by the Articles of Association as the qualification of a director, and the provisions as to remuneration of the directors.*

It is always interesting to see how much faith the directors have in the company. There is no legal compulsion for a company to fix a share qualification for its directors, but the public would draw its own conclusions if the directors had no personal interest in the company.

4. *The names, description, and addresses of the directors.*

The public must know the standing and quality of the board.

5. *The minimum amount which, in the opinion of the directors, must be raised by the issue in order to provide the sums, or if any part thereof is to be defrayed in any other manner, the balance of the sums required for—*

(*a*) *The purchase price of any property purchased or to be purchased which is to be defrayed in whole or in part out of the proceeds of the issue;*

(*b*) *Any preliminary expenses payable by the company and any commission so payable to any person in consideration of his agreeing to subscribe for or of his procuring or agreeing to procure subscriptions for any shares in the company;*

(*c*) *The repayment of any monies borrowed by the company in respect of any of the foregoing matters;*

(*d*) *Working capital.*

The prospectus must also show the amounts to be provided in respect of any of the above otherwise than out of the proceeds of the issue and the sources out of which these amounts are to be provided.

Even in the early days of companies there were many instances where the public did not respond to an issue of capital. The wholly inadequate amounts subscribed were, nevertheless, allotted, the promoters obtained their profits, and the concerns promptly died through

lack of capital. In the previous chapter we have seen how companies have endeavoured to protect themselves through the practice of underwriting from a recurrence of this unfortunate state of affairs. Underwriting, however, has been purely a commercial growth, and, as we have seen, it was frowned on by the law until the Companies Act of 1900.

The legislature tackled the problem of the allotment of insufficient capital from quite a different point of view. The various Companies Acts, up to and including the great consolidating Act of 1908, provided that the Memorandum or Articles must state the minimum subscription on which the company could proceed to allotment, that this minimum subscription must be set out in the prospectus, and that no allotment of share capital offered to the public could be made unless the amount fixed as the minimum subscription had been subscribed. It was assumed that investors would use their common sense and refuse to support an issue unless, in their opinion, the minimum subscription was sufficient to carry out the company's programme as set forth in the prospectus.

To form a public company at least seven persons must sign the Memorandum of Association of the company, and each subscriber must take not less than one share in the company. The business world, of course, complies with the law. In practice, however, there is a tendency, so strong that it might almost be called an economic law, for the business world to satisfy the *minimum* requirements of the law, and the question of share issues has proved no exception to this rule. In the post-War period it gradually became the almost invariable practice for the Memorandum of Association to be signed by seven persons and no more; the Memorandum or Articles fixed the minimum

subscription at seven shares only, that is, one share for each person who signed the Memorandum; and the number of shares named in the prospectus as the minimum subscription was usually seven. All this, of course, was a flagrant violation of the spirit of the Companies Acts. Investors either did not possess the intelligence assumed by the Companies Acts, or they did not have the organized strength to counteract the tendency of promoters to fix the minimum subscription at the bare minimum required by the Acts.

Following the disastrous failures of 1927-1928, the public was so moved that the Companies Act of 1908 was thoroughly revised. The new requirements as to minimum subscription, as set out above, are designed to prevent allotments where capital insufficient for the purposes of the company has been subscribed. Not only must this amount be subscribed, but the sums stated in the prospectus as due on application for the shares must have been paid to and received by the company before it can proceed to allotment.

6. *The amount payable on application and allotment on each share, and in the case of a second or subsequent offer of shares, the amount offered for subscription on each previous allotment made within the two preceding years, the number of shares actually allotted and the amount, if any, paid on the shares so allotted.*

In practice the amount payable on application is not less than 5 per cent. The tendency of the issuing house is as a rule to make the amounts payable on application and allotment as small as possible, because in this way sub-underwriting is made easier owing to the smallness of the cheques that the sub-underwriters are called on to pay. On the other hand, it is in the interests of the promoters to have the amount payable on application and on allotment as large as possible,

owing to the effect this has of frightening off the weaker kind of sub-underwriter.

The information as to the degree of success attending previous issues of capital is obviously a valuable guide to the investor.

7. *The number and amount of shares or debentures issued within the two preceding years or agreed to be issued as fully or partly paid up otherwise than in cash, and in the latter case the extent to which they are so paid up, and in either case the consideration for which those shares or debentures have been issued or are proposed or intended to be issued.*

The public subscribe cash and are entitled to know the consideration for which shares or debentures previously allotted were issued.

8. *The names and addresses of the vendors, and the amount payable to each vendor, whether in cash, shares or debentures.*

There must be full disclosure of the purchase money paid to each vendor, whether he sells directly to the company or to the persons who sell to the company.

Under this section every person is deemed to be a vendor who has entered into any contract, absolute or conditional, for the sale or purchase of any property to be acquired by the company where—

(*a*) The purchase money is not fully paid at the date of issue of the prospectus;

(*b*) The purchase money is payable wholly or partly out of the proceeds of the issue of shares offered by the prospectus; or

(*c*) The contract depends on the result of the issue.

9. *The amount payable as purchase money in cash, shares or debentures, specifying the amount, if any, payable for goodwill.*

This section ensures that the goodwill figure is clearly and unequivocally stated.

10. *The amount of the underwriting commission payable, and the amounts (if any) which have been paid within the two preceding years.*

The date of the main underwriting contracts and the names of the underwriters must also be given (subsec. 13), and directors must disclose any interest they have in underwriting (subsec. 15).

11. *The estimated amount of preliminary expenses.*

These expenses include stamp duty on the capital, legal costs, outlay incurred in preparing the Memorandum and Articles, advertising the prospectus, etc., and usually amount to a substantial figure.

12. *The amount to be paid to any promoter, and any amounts paid to promoters within the two preceding years, with a statement of the consideration for such payments.*

A promoter has been defined as "one who undertakes to form a company with reference to a given object, to set it going, and who takes the necessary steps for that purpose." He brings the company into existence, and he stands in a fiduciary relation to it, just as if he were a trustee. He must disclose all profits he makes, and he will be required to refund to the company any undisclosed or secret profit that it may afterwards be discovered he has made.

13. *The dates of and parties to every material contract entered into by the company, and a reasonable time and place at which these contracts may be inspected.*

This clause does not apply to contracts entered into in the ordinary course of the company's business and to contracts concluded more than two years before the issue of the prospectus.

14. *The names and addresses of the auditors.*

The standing of the auditors is important, for they

will be the watchdogs of the shareholders. They will certify the annual accounts, and report to the shareholders thereon.

15. *Full particulars of the nature and extent of the interest of every director in the promotion of, or in the property proposed to be acquired by, the company, and any sum in cash or shares or otherwise paid or agreed to be paid to him to induce him to become or to qualify him as a director, or otherwise for services rendered by him in connection with the promotion or formation of the company.*

If the director is a member of a firm, the promotion interest of his firm or any sums payable to his firm must also be disclosed.

16. *Where the shares are of more than one class, the rights of voting conferred by the several classes of shares, and the rights in respect of capital and dividends attached thereto.*

Where the voting rights are, there lies the control of the company. It is essential that the rights of shareholders as to capital and dividend be stated clearly and unequivocally.

17. *In the case of a company which has been carrying on business, or of a business which has been carried on for less than three years, the length of time during which the business of the company, or the business to be acquired, as the case may be, has been carried on.*

This provision is an addition to previous company legislation by the Act of 1929. It was made necessary by the number of new companies floated in 1927-1928 that failed disastrously in 1928-1929. They were, in many cases, new and untried ventures, condemned to failure from the beginning. It is only right that the investor should clearly understand when he is putting his money into a concern with no history. Prospectuses in future must give precise information as to how long the business of the company making the issue has been

in existence. Promoters will no longer be able to camouflage the new company in the verbiage previously common in prospectuses.

It is interesting to note that the Committee of the London Stock Exchange have recently made a new rule designed to give similar protection to the investor after the issue has been made. Until such time as a new company has issued its first balance sheet and accounts, dealings in the shares will be specially marked in the published lists. The Committee also reserve the right to refuse dealings in shares of companies formed to develop a new process or patent until their first accounts have been published and examined.

Accountants' Reports to be Set Out in the Prospectus. In the past, one of the unwritten laws governing issues was that a certificate of past earnings certified by professional accountants should be given in the prospectus. The Fourth Schedule to the 1929 Act has now made this a statutory requirement. The relative section in the Act reads as follows—

1. A report by the auditors of the company with respect to the profits of the company in respect of each of the three financial years immediately preceding the issue of the prospectus, and with respect to the rates of dividends, if any, paid by the company in respect of each class of shares in the company in respect of each of the said three years, giving particulars of each such class of shares on which such dividends have been paid and particulars of the cases in which no dividends have been paid in respect of any class of shares in respect of any of those years, and, if no accounts have been made up in respect of any part of the period of three years ending on a date three months before the issue of the prospectus, containing a statement of that fact.

2. If the proceeds or any part of the proceeds of the issue of the shares or debentures are or is to be applied directly or indirectly in the purchase of any business, a report made by accountants who shall be named in the prospectus upon the profits of the business in respect of each of the three financial years immediately preceding the issue of the prospectus.

These are sound provisions. It is a matter of wonder that they were not made years ago. They ensure that the investor will have before him authoritative statements of the profit-history of the concern in which he is contemplating subscribing shares.

If a company has been carrying on business for less than three years the certificates of profits, dividends, etc., are required for the time during which the company has been operating.

The various statutory provisions which we have enumerated refer primarily to the first issues of capital by companies. Until 1929 many of the provisions relating to the prospectuses of new companies did not apply in the case of a prospectus issued more than one year after the company was entitled to commence business. Advantage of this was taken so often by companies who carried on business for a year without making an issue, or at any rate a large issue, in order to evade the prospectus requirements of the Companies Acts, that the new Act has made the statutory provisions apply to all prospectuses, with the relatively unimportant proviso that in the case of a prospectus issue more than two years after the date at which the company is entitled to commence business, the provisions regarding the Memorandum and the qualification, remuneration and interest of directors, the names, descriptions and addresses of directors, and the amount of the preliminary expenses, need not be stated. All the other provisions of the Act remain in force, no matter when the prospectus is issued. The only exception is in the case of a circular inviting existing members of a company to subscribe for further shares; they are supposed already to be aware of the true position of the company.

Abridged Prospectus. When a prospectus is published

as a newspaper advertisement, the advertisement need not set out the contents of the Memorandum. What is termed an "abridged prospectus" is sometimes advertised. It does not contain many of the disclosures required by the Act, and those who issue it try to cover themselves by stating that it is an invitation to apply for prospectuses and not an invitation to subscribe for shares. Such an advertisement, however, seems to be a prospectus under the terms of the Act, and it is probable that an applicant for shares, relying on the abridged prospectus, could afterwards recover damages from the directors for any loss he may have suffered.

Liability of Directors and Promoters. The Companies Acts seek to compel complete candour on the part of the directors in dealing with the investor. The divorce of ownership of capital from management, to which we referred in Chapter I, is becoming so complete in the case of the great public company, that the shareholder or potential shareholder knows only what the directors choose to tell him about the company. The legislature has good reason, therefore, in making sure that promoters and directors accept full responsibility for all statements contained in any invitation to the public to subscribe capital.

The promoters and the directors must take care not only that they disclose all matters which they are bound to disclose, but that they make no untrue statements in any part of the prospectus. If it can afterwards be proved that statements in the prospectus were untrue, they may be sued for damages for fraud or for misrepresentation, and the allotment of shares may be set aside.

Section 37 of the Companies Act of 1929 states that every director or promoter "shall be liable to pay compensation to all persons who subscribe for any

shares or debentures on the faith of the prospectus for the loss or damage they may have sustained by reason of any untrue statement therein, or in any report or Memorandum appearing on the face thereof, or by reference incorporated therein or issued therewith."

CHAPTER XIII

GENERAL FORM OF PROSPECTUSES: THE SHARE PROSPECTUS, THE DEBENTURE OR LOAN NOTE PROSPECTUS, OFFERS FOR SALE

SHARE prospectuses must all comply with the statutory rules, but, as one would expect, they vary considerably in general form according to the nature of the business in which the company is engaged.

The energies of every promoter are directed in the first place to secure a good "front page." On the front page appears a statement of the capital of the company, particulars of the issue, a note of any special rights attaching to the shares issued, the names of the directors, solicitors, bankers, auditors, brokers, and secretary. At the top of the page there is given the date when the lists will be closed, and it is stated that application will be made in due course for a quotation of the shares on the Stock Exchange. The success or failure of an issue largely depends on the nature of the front page. Investors are asked to put their savings in the public company. They are well aware that, although they become part proprietors of the capital of the company, they will, as shareholders, have just as much, and no more, influence in the direction of the company as, say, the electors of this country have in swaying the destinies of the Empire. The elector may or may not scrutinize the capabilities of his parliamentary candidate, but the investor is certainly going to examine with the greatest care the reputation and capacity of all those, from directors to auditors, who will be responsible for the safety and earning power of the money that he is entrusting to their care.

Within the prospectus, the objects of the issue, the history of the company, and the statement of profits should be clearly and plainly set forth. Past profits are certified by a professional accountant, and his full certificate appended, showing with precision the basis on which the profits have been calculated. It is essential that the profits for past years be stated for each of these years, for, if an average only is given, it is impossible to see how the profits have fluctuated, and one has reason to suspect that they have been decreasing. The assets of the company should also be separately valued by experts, and the basis of the valuation set out.

The investor who pays attention to these points, keeps in mind the nature of the statutory information given, and examines the names on the front page, is well equipped to form a judgment on the offer.

Debenture or Loan Note Prospectus. Until the Companies Act, 1929, companies offering debenture stock or loan notes were not required to furnish the information necessary in the share prospectus. The new Act, however, has brought debenture stock or loan note issues into line with share issues, and the provisions set out in Chapter XII now apply to debenture or loan issues. The general form of the prospectus in these issues, however, is not quite the same as that of the share prospectus.

An offer of debenture stock appeals to a somewhat different class of investor than does an offer of shares. It appeals to the man who, on condition that his capital is secure, is content with a moderate rate of interest, independent of the amount of profits earned by the company. When the late head of the Rothschild family was asked for advice about investments, he used to inquire: "Do you want to eat well or to sleep

well?" The holder of debenture stock wants to sleep well, untroubled by doubts as to the safety of his capital. The debenture prospectus must, therefore, besides the usual information regarding the history of the company, the objects of the issue, and so on, deal specifically with certain points designed to set the investor's mind at rest.

1. The most important part of the offer is the valuation of the assets that secure the loan. The properties should be valued by a well-known and reputable firm of valuers; the values of each one should, if possible, be noted separately, and the basis of the valuation detailed. The borrowing powers of the company must be stated, and an indication given of the company's intentions to use these borrowing powers in the future. The investor wants to see that future issues of loan or debenture stock will not be made to the detriment of his security. He will therefore make sure that the tangible assets are ample to cover the total amount of borrowings authorized, and not simply the amount of the offer in which he is considering a participation. For the same reason, unless the issue is a second or third charge on the assets of the company, he requires an assurance that there are no debentures or mortgages or loans that have a prior claim on the assets. If the issue is a second or third charge, it is just as important to know exactly the nature and extent of the prior charges so as to give the necessary data to judge whether, in all the circumstances, they are too heavy or not.

It should be noted that a debenture is usually secured not only by a mortgage of specific properties, but by a floating charge on the undertaking and general assets of the company, including its uncalled capital. If there is any uncalled capital, this may be a reserve of

some importance from the point of view of the debenture-holder.

2. Ranking only second in importance to the valuation of the properties mortgaged is the certificate of profits, showing the extent to which interest on the loan is covered by earnings. The first point gives an assurance as to the principal of the loan, the second as to the regular payment of interest. Interest on debentures ought to be covered at least several times. When the properties are valued as a going concern and show but a small surplus over the amount of loans authorized, and when the service of the loan is covered by interest twice or perhaps three times only, the investor is going to exercise great caution, for his security in such a case depends on prospects rather than on performance. Prospectuses are invariably optimistic. If the promise of the one under consideration is not realized, the holder of debenture stock may find his interest fall in arrears and discover that the usual remedy of the debenture-holder avails him little. Properties valued on the basis of a going concern have a habit of realizing only a fraction of that value when a forced sale is made. The investor whose goal is safety will put such a prospectus in the waste-paper basket, or pass it on to his more speculative brother. The latter will realize at once that he is confronted with the usual risk of the share issue and will judge it from that point of view. He will require a high rate of interest, and if the debentures carry participation rights in the profits or are convertible into shares on some eventuality, so much the better. A debenture issue of this type, when the amount of the debentures often equals or exceeds the total share capital, is leading us far away from the traditional idea of debenture stock as a semi-gilt-edged investment. A few

years ago the public issue of debenture stock was the recognized method for the strong industrial or financial concern to raise money cheaply by giving overwhelming security. The assets of such a company covered the issue several times, and the interest was covered over and over again by current earnings. In the new type of issue the holders of the debenture stock often carry a large share of the business risk of the enterprise.

Debentures or notes are sometimes issued in the case of a new company. There obviously cannot be a certificate of profits, but it will usually be found that such a company is an offshoot or subsidiary of an old-established company, and that the interest is guaranteed by the parent company. The profits of the parent company, as certified, should be set out in the prospectus or offer for sale, and they will, of course, in conjunction with the valuation of the assets, form the basis of a judgment of the stability of the debentures.

3. The third important consideration in the debenture prospectus is the provision made for the redemption of the debentures. There is such a thing as irredeemable debenture stock, but it is rarely met with. As a rule debentures are redeemable within a fixed time, and an amount is set aside each year and placed in a sinking fund for their redemption. The important points to be emphasized in the prospectus are the date when the sum will begin to be set aside for sinking fund, the proportion of this sum to the debenture debt, whether the debentures or notes will be redeemed at fixed intervals by drawings at par or by purchases in the open market, the last date of redemption, and the premium payable at that date on stock that has not been drawn previously or cancelled by purchases in the market. The notice to be given by the company

if it wants to redeem the issue before the due date should also be noted.

Offers for Sale. Very often the issuing house acts as principal and not as intermediary in a debenture or loan note prospectus. It buys the whole issue from the company and sells it to the public at a profit. The prospectus is then called an "Offer for Sale." Prior to the passing of the 1929 Act it was not an unusual event even for share issues to take the form of an offer for sale. The company allotted the whole of the proposed issue to some other company or group of persons, who thereupon issued the shares to the public. Technically the prospectus was not then issued "by or on behalf of the company." The persons issuing it did not, therefore, incur the very onerous responsibilities of directors or promoters for statements in the prospectus, and the statutory requirements as to the contents of the prospectus were evaded. Section 38 of the Act of 1929 has set this matter right by providing that where a company allots any shares or debentures with a view to these shares or debentures being offered for sale to the public, any document by which the offer for sale to the public is made shall for all purposes be deemed to be a prospectus issued by the company, and all enactments and rules of law as to the contents of prospectuses and to liability in respect to statements in and omissions from prospectuses shall apply. To make the position quite clear, the Act lays down that—

it shall, unless the contrary is proved, be evidence that an allotment of, or an agreement to allot, shares or debentures was made with a view to the shares or debentures being offered for sale to the public if it is shown:

(*a*) That an offer of the shares or debentures or of any of them for sale to the public was made within six months after the allotment or agreement to allot: or

(*b*) That at the date when the offer was made the whole consideration to be received by the company in respect of the shares or debentures had not been so received.

From the investor's point of view, attention should be directed to the price at which the issuing house has bought the shares or debentures offered. If there is too big a difference between the purchase and issue price, it may be taken for granted that the issue is a risky one. As a rough guide, we might say that in normal circumstances 4 per cent is a liberal allowance—2 per cent for underwriting, including over-riding commission, and 2 per cent for legal, etc., expenses, advertising and brokerage. From the nature of the security, underwriting rates for a debenture issue should, of course, be much lower than for a share issue.

Issues on Behalf of Foreign and Colonial Companies. An offer for sale is made not only by an issuing house issuing debenture stock or loan notes for a British concern. Foreign and colonial companies making issues of shares or loan stock rarely put the issues directly on the market; they dispose of them in a block to a financial institution, which is the real seller to the public. The financial institution is usually one of our merchant banks who specialize in issues of this sort. In an offer for sale of this nature the standing of the issuing house is very important, and the profit on the transaction taken by it will furnish a good guide to the soundness of the issue.

CHAPTER XIV

PROSPECTUS "FOR INFORMATION ONLY"—THE PUBLIC LOAN PROSPECTUS—HOW AN ISSUE IS MADE

THERE is one type of prospectus fairly often seen nowadays that we have not mentioned—the prospectus "for information only." This document states prominently that it is not an invitation to subscribe for shares; it is merely an advertisement by an established company of the information required by the Stock Exchange before an official quotation for its shares can be obtained. It is quite a legitimate way of interesting the public in a company, but the information given is not so full as that required by the share prospectus. A group of men finance a company in its early stages, but they do not want their money to be tied up indefinitely. When the possibilities of the company are demonstrated, they obtain a quotation on the Stock Exchange after advertising the information required by that body and then dispose of their shares to the public. As the companies concerned are usually of a special type, and the men who have financed them at the beginning have taken all the risk, there is much to be said for the theory that they deserve the profits made in this way. Let us take as one of many possible examples a sugar beet company formed some years ago, when sugar beet flotations were, as they still are, unpopular. A public issue would undoubtedly have failed, but the capital was provided by the contractor who built the factory, the engineering firm who supplied the machinery, the sugar brokers who had an understanding that they would dispose of the output,

and, to a small extent, the farmers whose beet would be used as raw material. When the factory was built and substantial profits were visible, a prospectus "for information only" was published, and a quotation obtained on the Stock Exchange. The shares soon commanded a premium, and the contractors, engineers, and brokers disposed of their holdings to the public at a profit.

In 1927 and 1928, however, this method of finding capital was much abused. As the prospectus "for information only" did not require to make all the disclosures necessary in the prospectus inviting the public to subscribe for shares, many not too reputable company promoters saw in it a convenient method of foisting doubtful companies on to the public. To deal with this situation the Committee of the London Stock Exchange have now decided, before giving their permission to deal, to make their examination into such companies even more stringent than into those companies that issue their prospectuses to the public in the usual way.

Public Loans. The public loan prospectus is perhaps the simplest of all, and it is the easiest to judge, for the credit status of the borrower is a matter of common knowledge.

When a foreign government or municipality desires to raise a loan in London, its representatives sound those of our merchant bankers who specialize in such issues. In the course of the past fifty years there has grown up what is almost a tradition in the placing of loans of this type. One bank is associated with Brazilian loans, another with German loans, and so on, but the prestige even of banks rises and falls, and there is a certain amount of competition for any loan of a good type.

The borrowing State wants the best terms it can get; but it must remember that, besides the cost of underwriting, brokerage, advertising, and the profit of the issuing house, it must pay a capital duty of 2 per cent on bearer bonds or securities.

This heavy stamp duty makes the net proceeds of a loan rather less when floated in London than when floated on similar terms in New York, Amsterdam, or one of the other money centres.

The bank must consider a variety of questions before coming to a decision, and the answers it finds to these questions finally appear in one shape or another in the prospectus. These considerations may be summarized shortly.

1. *The integrity of the State or municipality.*

What is its past loan record? Has it ever defaulted in the service of a loan?

2. *The specific securities offered for the loan and their worth in case of default.*

3. *The extent to which the service of the loan is covered by specific revenues.*

It is always a good point also if monthly remittances of one-twelfth of the annual interest are sent to London, and if the London bankers hold in reserve a sum equal to one full half-year's service of the loan.

4. *The purpose of the loan.*

When the proceeds of the loan are to be used for productive purposes, there is a greater willingness to lend than when the money will be used for unproductive purposes. The popular appeal, too, will be strengthened if it provides a market for British equipment.

5. *The price at which the loan can be put on the market in relation to other issues of the same class.*

This is where the bank's judgment is tested. The issue price depends on a variety of considerations—the

state of the money market, the popularity of the borrowing State, the market price of previous loans issued on behalf of the same borrower, the temper of the investing public, whether the loan is sufficiently large to make it freely marketable, and so on.

6. *The provisions made for redemption of the loan, and to ensure that principal and interest will be free of all foreign taxes.*

When a decision has been arrived at on these points, the prospectus is drawn up and advertised in the usual way.

How an Issue is Made. Now that we have discussed the various types of prospectus, it is relevant to see how an issue is actually made.

When the terms of the issue have been agreed, the underwriting placed, the brokers, bankers, auditors, and solicitors appointed, and the prospectus prepared, the issuing house launches its campaign. Two or three days at the most should suffice from the time of sending out the prospectuses to the closing of the subscription lists.

There are agencies that collect and classify lists of shareholders of public companies, and are able in a few hours to have several hundred thousands of prospectuses ready for dispatch to investors likely to be interested in any particular issue. The issuing house hands over the prospectuses to the agency so that investors will have them on the morning of the issue. The week-end before the issue an advance announcement is usually made in the financial weeklies and in the Sunday newspapers, and a few days before the issue advance copies of the prospectus are sent to the financial editors of all the newspapers in which it is proposed to advertise the prospectus on the day of issue. Nowadays, when so many people read the

financial columns of the Press, it is most important to have some sort of editorial notice of a new issue. Stockbrokers and accredited agents are sent supplies of the prospectuses for their clients, with a slip informing them of the brokerage they will receive on all applications accepted bearing their stamp.

On the day of issue, applicants forward their application form, with its accompanying cheque, to the bankers of the company. The bankers enter the money, and send the application forms to the issuing house. If the issue is over-subscribed, the application lists may be closed in half an hour; if response is slow, they may be kept open for a day or two.

When the lists are closed, the directors proceed to examine the applications. If the issue is over-subscribed, applications may be balloted or proportionate allotments made. If the issue has failed, allotments will be made to the underwriters. Lastly, letters of regret are posted to applicants who have been unsuccessful in a ballot or whose applications have been refused, and letters of allotment are sent to the successful applicants.

CHAPTER XV

DIFFERENCES BETWEEN BRITISH AND FOREIGN METHODS OF FINDING CAPITAL

THE fundamental difference between raising capital in Great Britain and in the other great countries of the world is to be found in the function of the banks. If there is one thing that may have startled the reader of these pages, it is the realization of the very small part the British banks play in providing capital. Even in the prospectus of the public company, the bank is merely the agent for receiving subscriptions; it regards its responsibility towards the investor as practically non-existent. Largely as a result of the disastrous issues in 1928, the bank now scrutinizes very closely, it is true, the nature and capacity of the underwriters, but this is at best a negative safeguard. In the world outside Great Britain it is an accepted doctrine that the proper and primary business of a banking system is to provide or arrange the long term finance of industry and trade. As we have seen in Chapter IX, however, British banks resolutely refuse to furnish or to sponsor the provision of the permanent capital of a business. They will provide the short term finance by way of discounting bills of exchange or by making secured advances, but they will have nothing to do with long term finance. They have developed as banks of deposit. Their capital is relatively small compared with their enormous resources. These resources consist of the deposit of other people's money. Any investment of these resources must be of the most liquid nature. The three months' bill of exchange or the overdraft recallable at demand constitutes the limit, therefore, to which

the banks are prepared to go in assisting industry and trade. Long term finance is alien to the fundamental conceptions of British banking. The energies of our banking system have been devoted to two great functions—the creation and circulation of the cheque, our real home currency, and of the short term bill, the London bill, our international currency.

We were a great commercial nation long before the Industrial Revolution. Our banks have concerned themselves with the needs of commerce rather than of industry, and as a consequence they have paid more attention to international finance than to the requirements of the home capital market. When the Industrial Revolution gathered force in the early nineteenth century, the units of industry were small, and they were financed on a family basis. It is interesting to note how many of our greatest industrial concerns have, or until lately had, family names. The small units were extended out of profits, or additional capital was obtained from relatives and friends. England had a great start in the industrial race. Wages and costs were relatively low, and there was a great and rapid accumulation of wealth in the hands of the manufacturing class. An experienced type of investor came into being. As the century proceeded and the industrial unit became larger, there was still no difficulty in finding capital for the new or growing concern. It was found among friends or relatives or through the public issue as safeguarded by the Companies Acts. There was no necessity to go to the big banks, and there was no necessity for the creation of special machinery for the provision of capital. This suited our nineteenth century industrialist. He could use the banks when convenient for short term finance, but he kept the control of his business.

The case was different in the international sphere. London was the world's greatest money market; foreign governments and municipalities, great transport companies and the like, looked to London not only for short term but also for long term finance. A number of the great private banks made themselves responsible for such long term finance by way of loan or capital issue; they were our first issuing houses. In fact, if you to-day mention the word "issuing house" to the elderly city man, he usually assumes that you mean one of the banks that specialize in foreign issues. These houses take the greatest pains in examining any proposition submitted to them; they vouch for the issue. But such are tradition and specialization that practically without exception these houses do not touch home industrial issues.

We entered the twentieth century, then, with an elaborate specialized machinery for finding capital for foreign issues, but no systematic machinery for financing home industries. Twentieth century industry, however, is developing rapidly; it has become large-scale and international in scope. The rest of the world has caught up with us in the older industries, and we realize that, if we are to maintain our position, we must meet the challenge by increased specialization and by the creation of new industries. Issues of capital are, therefore, much more frequent and often on a scale quite undreamt of last century; but our financial institutions have not yet adapted themselves to the new needs at home. The old gap between finance and British industry has not been adequately bridged. In Chapter X we examined the function of the issuing house; but it should be remembered that the rise of the good issuing house is almost a post-War development, and one that still leaves much to be desired.

France. The capital issue in France is in the hands of the banks. The industrial bank was a French creation of the 'forties and 'fifties. The genius of Saint-Simon first appreciated that industry on the modern side requires special machinery for the provision of its capital, that the banks of deposit are unsuited to provide such finance, and that institutions must be created for this purpose. His disciples, the Pereires, formed in their Crédit Mobilier the first of these institutions. The Germans almost immediately seized on the idea and gave it its fullest modern expression. We quote below Dr. Goldschmidt's outline of the system. There are to-day a number of powerful French banks that have developed, not as banks of deposit like our English joint-stock banks, but as industrial banks having the closest relations with industry, both at home and abroad.

The French investor has always relied on his banker for advice on his investments, and in practice almost all industrial issues are made by the banks. The French banker in consequence assumes a responsibility for issues that is quite unknown among his English brethren.

Germany. The great industrial development of the country we now know as Germany commenced in the 'sixties. To appreciate the position, we must consider the condition of Prussia and the surrounding states at that time. They were poor. They had no accumulated stores of capital like England and France. They had few independent investors. They were late in the industrial race. But they had able and determined statesmen and financiers. These appreciated that if they were to catch up with the rest of the world their industries could not, as in England, rely on obtaining capital from private resources or from an unorganized

public. They turned to the French model. The banks were to come to the assistance of industry. The following quotation from the evidence given before the Macmillan Committee on Finance and Industry (Report, page 163) by Dr. Goldschmidt, gives the outline of the German system—

It should never be forgotten that Germany owes the great industrial development of the 'sixties, the 'nineties, and the first decade of this century in a large measure to what one may well describe as this "entrepreneur" spirit in banking . . . The relationship between a bank and an industrial or trading company commences with the latter's foundation. Scarcely a single important company in Germany has been founded without the collaboration of a bank. Whether it is a case of converting a private firm into a limited company, or of exploiting a new invention by establishing a new enterprise, the assistance of a bank is always invoked. The bank examines the situation, and when necessary obtains reports from experts in the particular line. . . . If the bank, after examination, decides to found the company, it draws up the scheme of financing, determines the amount and the type of capital to be issued, and then in some cases itself takes a part of the shares into its security portfolio with the idea of issuing them at a later date. In this way the founding bank becomes at the same time the issuing bank, the latter functions beginning, however, only with the introduction of the shares to the Stock Exchange through the intermediary of the bank.

What is of equal importance is that this system is adapted to the provision of intermediate credit, that is to say, of advances for periods of from one to ten years, and to financing long term contracts, hire-purchase or instalment sales, or advances against deferred payments.

United States. A quotation from the Macmillan Report (page 163) is again the most concise way of drawing the picture.

It was to the development of American industry in the widest sense that the financial world of New York devoted itself rather than to international finance. The great industries and the railroads were affiliated in general to particular banking houses, and in the building up, and in particular in the

merging, of most of the great American corporations. some house or bank has played a leading part, with the consequence that the relationship between them has usually remained a close and continuous one. It may be said that all industrial issues of well-known companies are sponsored by some responsible issuing institution, the smaller issues by smaller firms, the larger by larger firms or large banks. In both cases it is common for a group of issuing institutions to combine in making the issue. In every case the names of the issuing institutions appear prominently in the prospectus, so that the public are left in no doubt as to who is sponsoring the issue. Taking this responsibility, the issuing institution naturally attempts to keep in close and continuous touch with the company after the issue. So far as the large banks in New York, Chicago, and other centres are concerned, the issues in which they are interested are made usually through subsidiary Securities Companies. Moreover, the American banks are closely concerned with industry from another aspect. The banks lend either directly or through brokers very large amounts of money to investors and speculators against industrial securities of all kinds. The loans of this kind made by Reporting Member Banks are sometimes at least equal to the loans made direct by them to industry. For this reason also the banks take a great interest in the stock market and in the industrial securities quoted there.

Thus, under a different system, American banks, private and public, perform for American industry substantially the functions that German banks perform for German industry. The connection is a looser one; the number of banks competing is far greater; the problem of finding the necessary capital no doubt is much easier; and industry often needs banking assistance far less. Yet at the same time the American banks engage their issuing credit in the eyes of the public for the soundness of the issues they support, and this very fact leads, as it must always do, to a closer and more intimate association between banks and industry than where no such responsibility is assumed.

Development of the Issuing House in this Country. It is obvious that, to meet the changed conditions of the post-War industrial world, British finance must come to the aid of British industry on a scale and in a specialized manner hitherto unknown. Every kind of financial business can be put through in London; nowhere else in the world are there so many financial

institutions of the highest class. What is required is the proper systematic and regular co-ordination of existing energies and resources. Home industry must be put in a position to lay down initial equipment; it must be able to undertake the extensions and reconstructions rendered necessary by the progress of industrial technique and by the developments of foreign rivals; it must have facilities for raising quickly the large loans of an intermediate character that are so often essential to secure and finance big foreign contracts.

A number of issuing houses of excellent standing have since the War shown the way, but their scope and resources are inadequate to deal with industry's needs.

The Macmillan Committee on Finance and Industry recommends that the closer connection between British finance and industry be brought about by the big banks and the great private houses, who should themselves create new concerns devoted to industrial financing. They suggest that the Bankers' Industrial Development Company be definitely separated from the Bank of England, and form the first of such new organizations. They outline the functions of the new issuing house of this type as follows (page 172)—

> Acting as financial advisers to existing industrial companies; advising in particular as to the provision of permanent capital, its amounts and types; securing the underwriting of and issuing the company's securities to the public, and if necessary assisting previously in arranging for the provision of temporary finance in anticipation of an issue; assisting in financing long contracts at home and abroad, or new developments of an existing company, or founding companies for entirely new enterprises; acting as intermediaries and financial advisers in the case of mergers or in the case of negotiations with corresponding international groups, and generally being free to carry out all types of financing business.
>
> These are functions which are often difficult, which entail considerable risks, and which may involve the temporary locking up of large sums.

Such a concern must—

(*a*) Be provided with a substantial capital: where it is a case of financing large contracts for periods up to five years, it might be able to supplement its resources by the issue of its own short term notes;

(*b*) Be able to rely on the co-operation of existing institutions with large monetary resources in the making of temporary advances; otherwise it might either be unable to carry out its functions or its capital might have to be too big for it to earn satisfactory dividends;

(*c*) Build up a competent and expert staff; establish gradual connections with industry; and instil confidence in its issuing ability and credit.

The Committee also recommend that separate finance houses of this type be formed to devote themselves to the smaller industrial or commercial issue, up to, say, £200,000. The smaller and medium-sized business has always found difficulty in raising capital from the public, even when the security offered is perfectly sound. The expenses of a public issue have been too great in proportion to the capital raised, and there has also been the difficulty of making a market in the shares.

It remains to be seen how far the recommendations of the Macmillan Committee will be put into effect. As these recommendations crystallize the feeling that has been growing among both industrialists and financiers during the past twenty years, and as they represent a logical development of our financial system, we may hope that the new issuing house, devoting itself to the needs of home industries, will soon be a force among us.

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